



4-2004

## 24th Annual Conference on Legal Issues for Financial Institutions

Office of Continuing Legal Education at the University of Kentucky College of Law

**[Click here to let us know how access to this document benefits you.](#)**

Follow this and additional works at: [https://uknowledge.uky.edu/uky\\_cle](https://uknowledge.uky.edu/uky_cle)



Part of the [Banking and Finance Law Commons](#)

---

### Repository Citation

Office of Continuing Legal Education at the University of Kentucky College of Law, "24th Annual Conference on Legal Issues for Financial Institutions" (2004). *Continuing Legal Education Materials*. 63.  
[https://uknowledge.uky.edu/uky\\_cle/63](https://uknowledge.uky.edu/uky_cle/63)

This Book is brought to you for free and open access by the Kentucky Legal History at UKnowledge. It has been accepted for inclusion in Continuing Legal Education Materials by an authorized administrator of UKnowledge. For more information, please contact [UKnowledge@lsv.uky.edu](mailto:UKnowledge@lsv.uky.edu).

**UK  
CLE**

---

*24th Annual  
Conference on*

**LEGAL ISSUES FOR  
FINANCIAL  
INSTITUTIONS**

**April 2004**





**UK  
CLE**

---

*24th Annual  
Conference on*

**LEGAL ISSUES FOR  
FINANCIAL  
INSTITUTIONS**

**April 2004**

**Presented by  
OFFICE OF CONTINUING LEGAL EDUCATION  
UNIVERSITY OF KENTUCKY COLLEGE OF LAW**

FROM THE LIBRARY OF: \_\_\_\_\_  
\_\_\_\_\_

Written materials and oral presentations offered through the University of Kentucky College of Law Office of Continuing Legal Education (UK/CLE) are designed to assist lawyers in maintaining their professional competence. The Office of Continuing Legal Education and its volunteer speakers and writers are not rendering legal or other professional services by their participation in continuing legal education activities. Attorneys and others using information obtained from UK/CLE publications or seminars must also fully research original and current sources of authority to properly serve their or their client's legal interests. The forms and sample documents contained in our continuing legal education publications are intended for use only in conjunction with the professional services and advice of licensed attorneys. All parties must cautiously consider whether a particular form or document is suited to specific needs. The legal research presented herein is believed to be accurate, but is not warranted to be so. These written materials and the comments of speakers in presentation of these materials may contain expressions of opinion which do not necessarily reflect the views of the Office of Continuing Legal Education, the University of Kentucky, the Commonwealth of Kentucky, or other governmental authorities. UK/CLE strives to make its written materials and speaker presentations gender-neutral; however, gender-specific references may remain where it would otherwise be awkward or unclear. It should be understood that in such references the female includes the male, and vice-versa.

Copyright 2004 by the University of Kentucky College of Law,  
Office of Continuing Legal Education.  
All rights reserved.

Printed in the United States of America

### **UK/CLE: A SELF-SUPPORTING ENTITY**

The University of Kentucky Office of Continuing Legal Education (UK/CLE) is an income-based office of the University of Kentucky College of Law. As such, it is separately budgeted and financially self-supporting. UK/CLE operations are similar to not-for-profit organizations, paying all direct expenses, salaries and overhead solely from revenues. No public funds or tax dollars are allocated to its budget. Revenues are obtained from registrant enrollment fees and the sale of publications. Our sole function is to provide professional development services. In the event surplus funds become available, they are utilized to offset deficits or retained in our budget to improve the quality and variety of services we provide.

ABOUT ...

# UK CLE

---

The University of Kentucky College of Law, Office of Continuing Legal Education (UK/CLE) was organized in 1973 as the first permanently staffed, full time continuing legal education program in the Commonwealth of Kentucky. It endures with the threefold purpose: 1) to assist lawyers in keeping abreast of changes in the law; 2) to develop and sustain practical lawyering skills; and 3) to maintain a high degree of professionalism in the practice of law. Revenues from seminar registrations and publication sales allow the Office to operate as a separately budgeted, self-supporting program of the College. No tax dollars or public funds are used in the operation of UK/CLE.

## **Seminars**

UK/CLE provides a variety of convenient, practical seminars to satisfy the continuing legal education needs of lawyers. Seminars range from half-day programs in selected areas to in-depth programs extending over several days. While most seminars are conducted at the College of Law in Lexington, UK/CLE has a long-standing statewide commitment. Since its first year of operation, beginning with a criminal law seminar in Madisonville, Kentucky, the Office has continued to bring high-quality continuing legal education to attorneys in every region of Kentucky.

## **Publications**

Each seminar is accompanied by extensive speaker-prepared course materials. These bound course materials are offered for sale following seminars and are consistently regarded as valuable, affordable references for lawyers. Since 1987, UK/CLE has produced a series of Practice Handbooks and Monographs. Each Practice Handbook is an extensively referenced, fully indexed practice guide consisting of separately authored chapters, allowing for the comprehensive coverage of a distinct body of law. Their format permits updating through supplements and revised indices. Each Monograph is a concisely written practice guide, often prepared by a single author, designed to cover a topic of narrower scope than the Handbooks. They are convenient references on topics often not treated elsewhere. In 1995, UK/CLE began publication of its highly popular compendium series. Each compendium volume gathers several hundred pages of forms, charts, statistical data, case summaries or other reference material useful in all aspects of drafting, case evaluation, case management, and litigation.

## **Professional Management**

UK/CLE serves the needs of the bar from its offices on the University of Kentucky campus in Lexington. Its staff manages course registrations, publication planning and editing, publication sales, seminar and publication marketing, publication composition and printing, and seminar content planning, as well as budgeting, accounting and financial reporting. As an "income based" program, UK/CLE's seminar tuitions and publication sales are budgeted to generate sufficient revenues for self support.

### **Commitment to Quality and Creativity**

UK/CLE is a member of the Association for Continuing Legal Education (ACLE). As such, UK/CLE subscribes to the ACLE Standards in Continuing Legal Education and the Standards of Fair Conduct and Voluntary Cooperation, administered under the auspices of the American Law Institute-American Bar Association Committee on Continuing Professional Education. Throughout its existence UK/CLE has been actively involved in the activities and services provided by ACLE. UK/CLE's association with national and international CLE professionals has afforded it the opportunity to continually reassess instructional methods, quality in publications, and effective means of delivering CLE services at consistently high levels of creativity and quality.

### **An Integral Part of the Legal Profession's Tradition of Service**

An enormous debt is owed to the judges, law professors, and practitioners who generously donate their time and talent to continuing legal education. Their knowledge and experience are the fundamental ingredients for our seminars and publications. Without their motivation and freely given assistance in dedication to a distinguished profession, high quality continuing legal education would not exist.

As a non-profit organization, UK/CLE relies upon the traditional spirit of service to the profession that attorneys have so long demonstrated. We are constantly striving to increase attorney involvement in the continuing education process. If you would like to participate as a volunteer speaker or writer, please contact us and indicate your areas of interest and experience.

**UNIVERSITY OF KENTUCKY  
COLLEGE OF LAW  
OFFICE OF CONTINUING LEGAL EDUCATION**

---

Suite 260 Law Building  
Lexington, Kentucky 40506-0048  
(859) 257-2921  
FAX (859) 323-9790  
Website: [www.uky.edu/Law/CLE](http://www.uky.edu/Law/CLE)

---

PRESIDENT, UNIVERSITY OF KENTUCKY

Lee T. Todd, Jr.

DEAN, COLLEGE OF LAW

Allan W. Vestal

---

DIRECTOR OF CLE

Kevin P. Bucknam

ASSISTANT DIRECTOR OF CLE

Timothy S. Chase

ADMINISTRATIVE/BUSINESS MANAGER

Melinda E. Rawlings

EDITORIAL/MARKETING ASSISTANT

William G. Nims

RESEARCH ASSOCIATES

Heather H. Wyrick  
Joseph A. MacLaren  
Brian S. Powers  
Tracy J. Taylor





**24<sup>TH</sup> ANNUAL**

**CONFERENCE ON LEGAL ISSUES FOR  
FINANCIAL INSTITUTIONS**

**TABLE OF CONTENTS**

**KENTUCKY GENERAL ASSEMBLY UPDATE ..... SECTION A**  
*Debra K. Stamper*

**ANNUAL CASE LAW UPDATE FOR BANK COUNSEL ..... SECTION B**  
*M. Thurman Senn*

**CIVIL LITIGATION RESULTING FROM THE ERPENBECK FRAUD:  
MITCHELL V. PEOPLES BANK OF NORTHERN KENTUCKY  
WHAT WERE THE ISSUES AND ARGUMENTS? ..... SECTION C**  
*John K. Bush*

**STATE PREDATORY LENDING & OCC PREEMPTION ..... SECTION D**  
*Caryn F. Price*

**BANKRUPTCY LAW UPDATE FOR BANK COUNSEL ..... SECTION E**  
*Lea Pauley Goff*

**CHECK CLEARING IN THE 21<sup>ST</sup> CENTURY ACT ..... SECTION F**  
*Jane Hils Shea*

**UPDATE FROM THE CHICAGO REGIONAL OFFICE OF THE FDIC .. SECTION G**  
*Timothy E. Divis*

**RECENT DEVELOPMENTS UNDER THE UNIFORM  
COMMERCIAL CODE ..... SECTION H**

*John T. McGarvey*

**HIPAA AND FINANCIAL INSTITUTIONS ..... SECTION I**

*Vickie Yates Brown*

**THE FAIR AND ACCURATE CREDIT TRANSACTION ACT OF 2003 .... SECTION J**

*Martha A. Ziskind*

**TAX & STRUCTURAL ISSUES FOR BANKS AND  
FINANCIAL INSTITUTIONS ..... SECTION K**

*Walter R. Byrne, Jr.*

*Thomas J. Lubner*

**KENTUCKY GENERAL ASSEMBLY UPDATE**  
**--New Kentucky Legislative Enactments--**

*Debra K. Stamper*  
*General Counsel*  
*Kentucky Bankers Association*  
*Louisville, Kentucky*

Copyright 2004. Debra K. Stamper. All Rights Reserved.

**SECTION A**



## KENTUCKY GENERAL ASSEMBLY UPDATE

### New Kentucky Legislative Enactments

**I. Introduction.** The materials included in this summary were accumulated as of March 30, 2004 and based upon bills introduced in the Kentucky 2004 General Session. There are, however, two voting days and veto periods still open as of the date of this publication. The bills summarized here include issues of particular importance to financial institutions doing business in Kentucky. Detailed information will be provided to financial institutions next month in a booklet produced by the Kentucky Bankers Association entitled 2004 Session in Summary. Most of the bills summarized are included with these materials. Bills not included may be obtained through the LRC Website at [www.lrc.state.ky.us](http://www.lrc.state.ky.us) or by contacting Debra Stamper at 502-582-2453 or [dstamper@kybanks.com](mailto:dstamper@kybanks.com).

**II. Scanning Credit Card Information.** (HB7—Delivered to the Governor on March 23). Prohibits the fraudulent use of any electronic devices that store or retrieves data or identification information from debit and credit cards and makes such fraudulent use a felony.

**III. Employer References.** (HB48—Delivered to the Governor on March 26). Provides immunity from civil liability to employers who give references requested by employer, previous employee or prospective employer so long as information given is not known to be false (or given without regard to whether it is true or not), so long as it is not given with the intent to mislead or so long as it is not given for prohibited discriminatory purposes.

**IV. Bank Branching Reciprocity.** (HB319—signed by the Governor on March 22). Places restrictions on out-of-state banks seeking to branch into Kentucky, by providing that if the laws of the home state of the out-of-state bank would place more restrictive terms or conditions on Kentucky banks seeking to acquire or merge with a bank in that state, then the interstate merger or branching of the out-of-state bank into Kentucky would be allowed only under substantially the same terms and conditions.

**V. Licensing of Home Inspectors.** (SB34—This has not been delivered to the Governor, so it may not pass). Establishes licensing requirements, continuing education and minimal experience requirements for home inspectors. It also establishes a procedure for complaints against a home inspector. Create a Board of Home Inspectors for oversight purposes.

**VI. Release of Motor Vehicle Liens.** (SB181—Delivered to the Governor on March 22). Requires that a secured party deliver an authenticated termination statement in compliance with KRS 355.9-513 and 186A.195, when the security interest in the motor vehicle has been discharged.

**VII. Certificates of Deposit.** (SB225—Delivered to the Governor on March 26). Requires automatically renewing certificates of deposit to be renewed at the best available rate of interest (as posted at the issuing financial institution) at that time for similarly issued CD's. Requires notice of the same to be included in any notice that the financial institution sends out regarding the upcoming renewal. Violation is an unfair trade practice.

**VIII.** Corporate License Tax. (ITW). Elimination of the corporate license tax is included in the Governor's tax reform package which has been attached to the budget and which is in conference at the date of publication.

**IX.** Predatory Lending. Elimination of the restriction against financing single premium insurance products on high cost loans is still under consideration at the date of publication.

We will keep you posted on changes and representatives of the Kentucky Bankers Association will be happy to speak to your officers or directors about this issue, upon request.

AN ACT relating to consumer protection.

***Be it enacted by the General Assembly of the Commonwealth of Kentucky:***

SECTION 1. A NEW SECTION OF KRS 434.550 TO 434.730 IS CREATED TO READ AS FOLLOWS:

- (1) No person shall use a scanning device to access, read, obtain, memorize, or store, temporarily or permanently, information encoded on the magnetic strip or stripe of a payment card with the intent to defraud the authorized user, the issuer of the authorized user's payment card, or a merchant.**
- (2) No person shall use a reencoder to place information encoded on the magnetic strip or stripe of a payment card onto the magnetic strip or stripe of a different card with the intent to defraud the authorized user, the issuer of the authorized user's payment card, or a merchant.**

Section 2. KRS 434.560 is amended to read as follows:

As used in KRS 434.550 to 434.730, unless the context otherwise requires:

- (1) "Automated banking device" means any machine which when properly activated by a credit card, debit card or personal identification code will perform any of the following services:
- (a) Dispense money as a debit to the cardholder's savings or checking account; or
  - (b) Print the cardholder's savings or checking account balances on a statement; or
  - (c) Transfer funds between a cardholder's savings and checking account; or
  - (d) Accept payments on a cardholder's loan; or
  - (e) Dispense cash advances on an open end credit or a revolving charge agreement; or
  - (f) Accept deposits to a customer's savings or checking account; or
  - (g) Receive inquiries of verification of checks and dispense information which verifies that funds are available to cover said checks; or
  - (h) Cause money to be transferred electronically from a cardholder's account to an

account held by any business, firm, retail merchant, corporation, or any other organization;[-]

- (2) "Cardholder" means the person or organization named on the face of a credit or debit card to whom or for whose benefit the credit or debit card is issued by an issuer;[-]
- (3) "Credit card" means any instrument or device, whether known as a credit card, credit plate, credit number or by any other name, issued by an issuer for the use of the cardholder in obtaining money, goods, services or anything else of value on credit;[-]
- (4) "Debit card" means any instrument or device, known by any name, issued with or without fee by an issuer for the use of the cardholder in obtaining money, goods, services and anything else of value, payment of which is made against funds previously deposited by cardholder;[-]
- (5) "E.F.T. system" means an electronic funds transfer system whereby funds are transferred electronically from a cardholder's account to any other account;[-]
- (6) "Expired credit card" means a credit card which is no longer valid because the term shown on it has expired;[-]
- (7) "Expired debit card" means a debit card which is no longer valid because the term shown on it has expired;[-]
- (8) "Issuer" means the business organization or financial institution which issues a credit or debit card or its duly authorized agent;[-]
- (9) **"Merchant" means an owner or operator of any retail mercantile establishment or any agent, employee, lessee, consignee, officer, director, franchisee, or independent contractor of such owner or operator. "Merchant" also means a person who receives from an authorized user of a payment card, or someone the person believes to be an authorized user, a payment card or information from a payment card, or what the person believes to be a payment card or information**



from a payment card, as the instrument for obtaining, purchasing, or receiving goods, services, money, or anything else of value from the person;

(10) "Participating party" means a business organization or financial institution, or any duly authorized agent of such business organization or financial institution, which is obligated by contract to acquire from a person, business organization or financial institution providing money, goods, services or anything else of value, a sales slip, sales draft or other instrument evidencing a credit or debit card transaction and from whom the issuer is obligated by contract to acquire or participate in such sales slip, sales draft or other instrument;[-]

(11) "Payment card" means a credit card, charge card, debit card, or any other card that is issued to an authorized card user and that allows the user to obtain, purchase, or receive goods, services, money, or anything else of value from a merchant;

(12)~~(10)~~ "Presentation or presents" as used herein shall be construed to define those actions taken by a cardholder or any person to introduce a credit or debit card into an automated banking device or merely displaying or showing a credit or debit card to the issuer, a person or organization providing money, goods, services, or anything else of value, or any other entity with intent to defraud;[-]

(13)~~(11)~~ "Receives" or "receiving" means acquiring possession or control of a credit or debit card;[-]

(14)~~(12)~~ "Reencoder" means an electronic device that places encoded information from the magnetic strip or stripe of a payment card onto the magnetic strip or stripe of a different payment card;

(15) "Revoked credit card" means a credit card which is no longer valid because permission to use it has been suspended or terminated by the issuer;[-]

(16)~~(13)~~ "Revoked debit card" means a debit card which is no longer valid because permission to use it has been suspended or terminated by the issuer; and

**(17) "Scanning device" means a scanner, reader, or any other electronic device that is used to access, read, scan, obtain, memorize, or store, temporarily or permanently, information encoded on the magnetic strip or stripe of a payment card.**

Section 3. KRS 434.730 is amended to read as follows:

- (1) A person who has violated KRS 434.590 shall be guilty of a Class A misdemeanor.
- (2) A person who has violated KRS 434.600 shall be guilty of a Class D felony.
- (3) A person who has violated the provisions of subsection (1) of Section 1 of this Act shall be guilty of a Class D felony for the first offense and a Class C felony for each subsequent offense.**
- (4) A person who has violated the provisions of subsection (2) of Section 1 of this Act shall be guilty of a Class D felony for the first offense and a Class C felony for each subsequent offense.**

AN ACT relating to civil actions.

*Be it enacted by the General Assembly of the Commonwealth of Kentucky:*

SECTION 1. A NEW SECTION OF KRS CHAPTER 411 IS CREATED TO READ AS FOLLOWS:

(1) An employer who provides information about the job performance, professional conduct, or evaluation of a former or current employee to a prospective employer of that employee, at the request of that employee or prospective employer, shall be immune from civil liability arising out of the disclosure unless the plaintiff in the civil action proves:

(a) That the employer disclosed the information knowing that it was false, with reckless disregard of whether it was true or false, or with intent to mislead the prospective employer; or

(b) That the disclosure of the information by the employer constitutes an unlawful discriminatory practice under KRS Chapter 344.

(2) This section does not create a new cause of action or substantive legal right against an employer.

(3) This section does not limit an employer's immunity from civil liability or defenses established in another section of the Kentucky Revised Statutes or available at common law.



AN ACT relating to establishing bank branches.

***Be it enacted by the General Assembly of the Commonwealth of Kentucky:***

Section 1. KRS 287.920 is amended to read as follows:

- (1) As used in this section, unless the context requires otherwise:
  - (a) "Interstate merger transaction" means the merger or consolidation of banks with different home states, and the conversion of branches of any bank involved in the merger or consolidation into branches of the resulting bank; and
  - (b) "Resulting bank" means a bank that has resulted from an interstate merger transaction under this section.
- (2) A Kentucky state bank may establish, maintain, and operate one (1) or more branches in a state other than Kentucky in accordance with an interstate merger transaction in which the Kentucky state bank is the resulting bank, or if the other state permits, by acquisition of a branch or branches in the other state. Not later than the date on which the required application for the interstate merger transaction or branch acquisition is filed with the responsible federal bank supervisory agency, the applicant shall file an application on a form prescribed by the commissioner and pay the fee prescribed by KRS 287.480. The applicant shall also comply with the applicable provisions of KRS 287.180(2) and the commissioner shall base his or her approval or disapproval in the same manner as prescribed in KRS 287.180(2).
- (3) An out-of-state state bank may establish, maintain, and operate one (1) or more branches in Kentucky in accordance with an interstate merger transaction in which the out-of-state state bank is the resulting bank **in accordance with the requirements of Kentucky laws and administrative regulations. If the laws of the home state of the out-of-state bank place more restrictive terms or requirements on Kentucky state banks seeking to acquire and merge with a bank in that state, the interstate merger of the out-of-state bank may be allowed only under**

*substantially the same terms and conditions as applicable to Kentucky state banks in that state.* Not later than the date on which the required application for the

interstate merger transaction is filed with the responsible federal bank supervisory agency, the applicant shall file an application on a form prescribed by the commissioner, pay the fee prescribed by KRS 287.480, and agree in writing to comply with the laws of this state applicable to its operation of branches in Kentucky. The applicant shall also comply with the applicable provisions of KRS 287.180(2) and the commissioner shall base his or her approval or disapproval in the same manner as prescribed in KRS 287.180(2).

- (4) No interstate merger transaction under subsection (2) or (3) of this section shall be approved if the transaction would result in a bank holding company having control of banks or branches in this state holding more than fifteen percent (15%) of the total deposits and member accounts in the offices of all federally insured depository institutions in this state as reported in the most recent June 30 quarterly report made by the institutions to their respective supervisory authorities which are available at the time of the transaction.
- (5) An individual or bank holding company that controls two (2) or more banks may, from time to time, combine any or all of the commonly controlled banks in this Commonwealth into and with any one (1) of the banks, and thereafter the surviving bank shall continue to operate its principal office and may operate the other authorized offices of the banks so combined as branches of the surviving bank.
- (6) A branch of an out-of-state state bank may conduct any activities that are authorized under the laws of this state for state banks. Additionally, the branch of an out-of-state state bank is authorized to conduct any activities relating to the administration of trusts that are authorized under the laws of its home state, if the activities are conducted in conformity with the laws of its home state.
- (7) A branch of a Kentucky state bank located in a host state may conduct any activities

that are:

- (a) Authorized under the laws of the host state for banks chartered by the host state; or
- (b) Authorized for branches of national banks located in the host state, but whose principal location is in a state other than the host state.





AN ACT relating to home inspectors.

*Be it enacted by the General Assembly of the Commonwealth of Kentucky:*

SECTION 1. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

*As used in Sections 1 to 20 of this Act, unless otherwise provided:*

- (1) "Applicant" means an individual who applies for a license as a home inspector.*
- (2) "Board" means the Kentucky Board of Home Inspectors established in Section 3 of this Act.*
- (3) "Client" means an individual who contracts with a licensed home inspector to obtain a home inspection and subsequent written home inspection report.*
- (4) "Department" means the Kentucky Department of Housing, Buildings, and Construction.*
- (5) "Home inspection" means a visual analysis for the purpose of providing a professional opinion by a licensed home inspector, of the condition of a residential dwelling and the dwelling's attached garages and carports, any reasonable accessible installed components, and the operation of the dwelling's systems, including any controls normally operated by the owner of the dwelling, for systems and components in the standards of practice established by the board. Home inspection shall not include a code compliance inspection, or an inspection required under the National Manufactured Housing Construction and Safety Standards Act of 1974, 42 U.S.C. secs. 5401 et seq., as amended, and rules and regulations issued thereunder, or KRS 227.600 regarding manufactured homes.*
- (6) "Home inspection report" means a written report prepared by a licensed home inspector for compensation and issued after a home inspection. The report shall include the following:*
  - (a) A report on any system or component inspected that, in the professional opinion of the inspector, is significantly deficient;*

(b) The inspector's recommendation to repair or monitor deficiencies reported under paragraph (a) of this subsection;

(c) A list of any systems or components that were designated for inspection in the standards of practice adopted by the board but that were not inspected; and

(d) The reason a system or component listed under paragraph (c) of this subsection was not inspected.

(7) "Licensee" means a person who performs home inspections and who is licensed under Sections 1 to 20 of this Act as a home inspector.

(8) "Residential dwelling" means a structure consisting of at least one (1) but not more than four (4) units, each designed for occupancy by a single family, whether the units are occupied or unoccupied.

SECTION 2. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

Sections 1 to 20 of this Act shall apply to an individual who conducts home inspections for compensation, but shall not apply to the following:

(1) An individual who is acting within the scope of the individual's employment as:

(a) A code enforcement official for the state or a political subdivision of the state; or

(b) A representative of a state or local housing agency or an individual acting under the authority of the United States Department of Housing and Urban Development;

(2) An individual who is acting within the scope of the individual's license as a licensed:

(a) Architect under KRS Chapter 323;

(b) Professional engineer under KRS Chapter 322;

(c) Plumbing contractor or journeyman plumber under KRS Chapter 318;

- (d) Electrician, master electrician, or electrical contractor under KRS Chapter 227A;
- (e) Liquefied petroleum gas dealers under KRS Chapter 234; or
- (f) Master heating, ventilation, and air conditioning contractor, journeyman heating, ventilation, and air conditioning mechanic, or an apprentice heating, ventilation, and air conditioning mechanic under this chapter;
- (3) An individual licensed under KRS Chapter 324 as a real estate broker, broker-salesperson, or salesperson and is acting within the scope of the individual's license;
- (4) An individual who is licensed under KRS Chapter 324A as a real estate appraiser and is acting within the scope of the individual's license;
- (5) An individual who holds a license under KRS Chapter 304 as an insurance adjuster and is acting within the scope of the individual's license;
- (6) An individual who holds a permit, certificate, or license to:

  - (a) Use and apply pesticides; or
  - (b) Make diagnostic inspections and reports for wood destroying pests and fungi under KRS Chapter 217B and is acting within the scope of the individual's certificate or license;
- (7) An individual who holds a license from a political subdivision as a tradesperson or home builder and is acting within the scope of the individual's license;
- (8) An individual who holds a current and valid license, certificate, or permit under KRS 227.550 to 227.660 and is acting within the scope of the individual's license, certificate, or permit as a:

  - (a) Manufactured home retailer;
  - (b) Manufactured home certified retailer; or
  - (c) Manufactured home certified installer; or
- (9) Employees of the Department of Housing, Buildings and Construction or the

State Fire Marshall's Office acting in their official capacities as inspectors of buildings and manufactured housing.

SECTION 3. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

(1) There is created a board to be known as the Kentucky Board of Home Inspectors.

(2) The board shall be composed of ten (10) members appointed by the Governor.

(a) Five (5) of the members shall:

1. Have been actively engaged in performing home inspections in Kentucky for at least five (5) years immediately before the member's appointment to the board, or have completed one hundred (100) fee paid inspections per year over the last five (5) years;

2. Be licensed by the board as a home inspector; and

3. Be appointed as follows:

a. One (1) person shall be a member of the American Society of Home Inspectors;

b. One (1) person shall be a member of the Kentucky Real Estate Inspectors Association;

c. One (1) person shall be a member of the National Association of Home Inspectors; and

d. Two (2) persons shall be either at-large licensed home inspectors or owners or managers of a home inspection company actively performing home inspections within the Commonwealth of Kentucky. The company and its owner or manager shall have been actively engaged in the home inspection profession in Kentucky for a minimum of five (5) years. The company shall employ or contract with multiple licensed home inspectors in good standing with the Kentucky Board of Home Inspectors.

These five (5) members shall be selected from a list of fifteen (15) names submitted to the Governor, and compiled by a selection committee composed of six (6) members, two (2) each from the American Society of Home Inspectors, the Kentucky Real Estate Inspectors Association, and the National Association of Home Inspectors respectively.

(b) The other five (5) board members shall be qualified as follows:

1. One (1) person shall be a home builder who has been actively engaged in home building in Kentucky for at least five (5) years immediately before the member's appointment to the board. This member shall be selected from a list of three (3) names submitted to the Governor from the Home Builders Association of Kentucky;
2. One (1) person shall be a licensed real estate salesperson or broker under KRS Chapter 324 who has been actively engaged in selling, trading, exchanging, optioning, leasing, renting, managing, or listing residential real estate in Kentucky for at least five (5) years immediately before the member's appointment to the board. This member shall be selected from a list of three (3) names submitted to the Governor from the Kentucky Association of Realtors;
3. One (1) person shall represent the public at-large and shall not be associated with the home inspection, home building, or real estate business other than as a consumer. This member shall be appointed by the Governor, but shall not be selected from a submitted list of names;
4. One (1) person shall be a licensed manufactured home retailer, certified retailer, or certified installer who has been actively engaged in such an occupation for at least five (5) years immediately before the member's appointment to the board. This member shall be selected

from a list of three (3) names submitted to the Governor from the Kentucky Manufactured Housing Institute; and

5. The Executive Director of the Office of Housing, Buildings, and Construction, or his or her designee shall be a member of the board.

(3) A board member required to have a license in accordance with subparagraph 3. of paragraph (a) of subsection (2) of this section, shall obtain the requisite license in accordance with Section 7 of this Act, on or before July 1, 2006. If a board member does not obtain the requisite license on or before July 1, 2006, the board member shall be considered to have resigned from the board on July 1, 2006, and the Governor shall fill the vacancy in accordance with this section. If a board member resigns for failure to obtain a home inspectors license, the actions of the board member and board before July 1, 2006, shall be valid and viable.

(4) The members of the board shall be residents of Kentucky.

(5) The initial terms of office for the nine (9) members appointed to the board by the Governor are as follows:

(a) Three (3) members for a term of three (3) years;

(b) Three (3) members for a term of two (2) years; and

(c) Three (3) members for a term of one (1) year.

Thereafter, all members shall serve a term of three (3) years.

(6) The initial terms begin July 15, 2004.

(7) The Governor may remove a board member at any time for incompetence, neglect of duty, or unprofessional conduct.

(8) If a vacancy occurs in the membership of the board, the Governor shall appoint an individual to serve for the remainder of the unexpired term who has like qualifications required of the member who created the vacancy.

(9) A member shall not serve on the board for more than six (6) consecutive years.

(10) Each year the board shall elect a member as chairperson and a member as vice

chairperson.

- (11) The chairperson and vice chairperson shall serve in their respective capacities for no more than one (1) year consecutively and until a successor is elected.
- (12) The chairperson shall preside at all meetings at which the chairperson is present. The vice chairperson shall preside at meetings in the absence of the chairperson and shall perform other duties as the chairperson directs.
- (13) If the chairperson and vice chairperson are absent from a meeting of the board when a quorum exists, the members who are present may elect a presiding officer who shall serve as acting chairperson until the conclusion of the meeting or until the arrival of the chairperson or vice chairperson.
- (14) The board shall meet at least quarterly each calendar year upon the call of the chairperson or the written request of a majority of the members of the board.
- (15) The chairperson shall establish the date, time, and place for each meeting.
- (16) A majority of the current members of the board constitutes a quorum.
- (17) The affirmative vote of a majority of the members appointed to the board is necessary for the board to take official action.
- (18) Each member of the board is entitled to a minimum salary of thirty-five dollars (\$35) per diem. Each member of the board is entitled to reimbursement for traveling expenses and other expenses actually incurred in connection with the member's duties as established under KRS 45.101.

SECTION 4. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO  
READ AS FOLLOWS:

The board shall:

- (1) Through the promulgation of administrative regulations:
- (a) Determine the requirements for and prescribe the form of licenses, applications, and other documents that are required by Sections 1 to 20 of this Act; and

- (b) Require that a home inspection report include a statement that the home inspection report does not address environmental hazards, which shall be listed with specificity by the board;
- (2) Grant, deny, suspend, and revoke approval of examinations and courses of study regarding home inspections;
- (3) Issue, deny, suspend, and revoke licenses in accordance with Sections 1 to 20 of this Act;
- (4) Investigate complaints concerning licensees, or persons the board has reason to believe should be licensees, including complaints concerning failure to comply with Sections 1 to 20 of this Act or administrative regulations promulgated under Sections 1 to 20 of this Act, and, when appropriate, take action in accordance with Sections 15 and 16 of this Act;
- (5) Bring actions in the name of the state in an appropriate court in order to enforce compliance with Sections 1 to 20 of this Act or the administrative regulations promulgated under Sections 1 to 20 of this Act;
- (6) Establish fees in an amount not to exceed two hundred and fifty dollars (\$250) annually;
- (7) Inspect the records of a licensee in accordance with administrative regulations promulgated by the board;
- (8) Conduct or designate a member or other representative to conduct public hearings on any matter for which a hearing is required under Sections 15 and 16 of this Act and exercise all powers granted under KRS Chapter 13B;
- (9) Adopt a seal containing the words "Kentucky Board of Home Inspectors" and, through the board's secretary, certify copies and authenticate all acts of the board;
- (10) Use counsel, consultants, and other persons, enter into contracts, and authorize expenditures that are reasonably necessary or appropriate to administer and



enforce Sections 1 to 20 of this Act and administrative regulations promulgated thereunder;

(11) Establish continuing education requirements for licensed home inspectors in accordance with Sections 12 and 13 of this Act;

(12) Maintain the board's office, files, records, and property in the city of Frankfort;

(13) Require all fee-paid home inspections to be conducted in accordance with the standards of practice of:

(a) The American Society of Home Inspectors;

(b) The National Association of Home Inspectors; or

(c) Any other approved standards of practice that are equal to the standards of practice of the organizations in paragraphs (a) and (b) of this subsection.

The board may establish standards of practice for home inspectors licensed in Kentucky at a later date, which will supersede any other standards of practice previously adopted by the board.

(14) Exercise all other powers specifically conferred on the board under Sections 1 to 20 of this Act; and

(15) Promulgate administrative regulations to carry out the effective administration and the requirements of Sections 1 to 20 of this Act.

SECTION 5. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

The department shall provide the board with:

(1) Clerical or other assistants, including investigators, necessary for the proper performance of the board's duties;

(2) A place to hold board meetings and hearings; and

(3) Office equipment and office space for board records, staff, and other effects necessary to carry out the requirements of Sections 1 to 20 of this Act.

SECTION 6. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO

READ AS FOLLOWS:

- (1) There is established in the State Treasury a revolving fund for the use by the board.
- (2) All fees and other money received by the board in accordance with Sections 4, 7, 8, 12, and 13 of this Act shall be deposited in the revolving fund established in subsection (1) of this section.
- (3) No part of this revolving fund shall revert to the general fund.
- (4) The compensation of board members and all of the board's expenses incurred by the board shall be paid from this revolving fund, except the assistance set forth in Section 5 of this Act.

SECTION 7. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO  
READ AS FOLLOWS:

- (1) An individual shall not advertise or claim to be a licensed home inspector and shall not conduct a home inspection for compensation without first obtaining a license as a home inspector.
- (2) The board shall deny a license to any applicant who fails to:
  - (a) Furnish evidence satisfactory to the board, showing that the individual:
    - 1. Is at least eighteen (18) years of age;
    - 2. Has graduated from high school or earned a Kentucky or other state's general educational development (GED) diploma; and
    - 3. Meets other criteria established by the board.
  - (b) Verify the information submitted on the application form;
  - (c) Complete a board approved training program or course of study involving the performance of home inspections, and pass an examination prescribed or approved by the board;
  - (d) Submit to the board a certificate of insurance that is acceptable to the board and that:

1. Is issued by an insurance company or other legal entity authorized to transact insurance business in Kentucky;
  2. Provides for general liability coverage of at least two-hundred and fifty thousand dollars (\$250,000);
  3. Lists the state as an additional insured;
  4. States that cancellation and nonrenewal of the underlying policy is not effective until the board receives at least ten (10) days prior written notice of the cancellation or nonrenewal; and
  5. Contains any other terms and conditions established by the board.
- (e) Pay a licensing fee established in Section 4 of this Act.
- (3) A person applying for a license as a home inspector shall apply on a written or electronic form prescribed and provided by the board.

SECTION 8. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

- (1) The licensing requirements for a home inspector may be waived for a person moving to Kentucky from another jurisdiction, and the person may be granted a license as a home inspector if the person meets the following requirements:
- (a) The other jurisdiction grants the same privileges to licensees of Kentucky as Kentucky grants to licensees of that other jurisdiction;
  - (b) The person is licensed in the other jurisdiction;
  - (c) The licensing requirements of the other jurisdiction are substantially similar to the requirements of Sections 1 to 20 of this Act; and
  - (d) The person states that he or she has studied, is familiar with, and will abide by Sections 1 to 20 of this Act and the administrative regulations promulgated by the board.
- (2) A person seeking a license as a home inspector under this section shall:
- (a) Apply on a form prescribed and provided by the board; and

(b) Pay the applicable licensing fee established by the board.

SECTION 9. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

(1) A nonresident whom the board determines meets the requirements of Sections 1 to 20 of this Act and who files the written consent described in subsection (2) of this section may be licensed as a home inspector in Kentucky.

(2) A nonresident applicant shall file with the board a written consent stating that, if licensed:

(a) The applicant agrees to the commencement of any action arising out of the conduct of the applicant's business in Kentucky in the county in which the events giving rise to the cause of action occurred;

(b) The applicant:

1. Agrees to provide to the board the name and address of an agent to receive service of process in Kentucky; or

2. Consents to the board acting as the applicant's agent for the purpose of receiving service of process if:

a. An agent's name and address have not been filed with the board;

or

b. The agent's name and address on file with the board are incorrect; and

(c) The applicant agrees that service of process in accordance with the Kentucky Rules of Civil Procedure is proper service and subjects the applicant to the jurisdiction of Kentucky courts.

SECTION 10. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

All licenses issued by the board shall remain the property of the board.

SECTION 11. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO

READ AS FOLLOWS:

A licensee shall notify the board within thirty (30) days of any change of:

- (1) Name;
- (2) Name under which the licensee conducts business; or
- (3) Business address.

SECTION 12. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO  
READ AS FOLLOWS:

- (1) The initial license for a home inspector issued in accordance with Sections 1 to 20 of this Act, shall expire on the last day of the licensee's birth month in the following year. The board may reduce the license fee on a pro rata basis for initial licenses issued for less than twelve (12) months.
- (2) Renewed licenses shall expire on the last day of the licensee's birth month of each even numbered year after the date of issuance of the renewed license.
- (3) An individual who applies to renew a license as a licensed home inspector shall:
  - (a) Furnish evidence showing successful completion of the continuing education requirements of this section;
  - (b) Pay the renewal fee established by the board; and
  - (c) Show proof of general liability insurance in the amount required by subsection (2)(d) of Section 7 of this Act.
- (4) Renewal notices shall be sent to each licensee at least sixty (60) days prior to the expiration of the license. The notice shall inform the licensee of the need to renew and the requirement of payment of the renewal fee. If this notice of expiration is not sent by the board, the licensee is not subject to a sanction for failure to renew if, once notice is received from the board, the license is renewed within forty-five (45) days of the receipt of the notice.
- (5) Renewal fees shall be paid with a draft, a money order, a cashier's check, a certified or other personal check, or if payment is made in person, the payment

may be made in cash. If the board receives an uncertified personal check for the renewal fee and if the check does not clear the bank, the board may refuse to renew the license.

(6) Before the end of each license period, each licensee shall complete the continuing education required by the board. This requirement shall not exceed thirty (30) hours per two (2) year license cycle. This requirement shall be effective beginning January 1, 2005.

(7) The board may, through the promulgation of administrative regulations:

(a) Establish an inactive license for licensees who are not actively engaging in the home inspection business but wish to maintain their license;

(b) Reduce license and renewal fees for inactive licenses; and

(c) Waive the insurance requirements established in Section (7) of this Act for inactive licenses.

SECTION 13. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

The board shall promulgate administrative regulations concerning the continuing education required for the renewal of a home inspector license and shall:

(1) Establish procedures for approving organizations that provide continuing education; and

(2) Prescribe the content, duration, and organization of continuing education courses that contribute to the competence of home inspectors.

SECTION 14. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

(1) As used in this section, "political subdivision" means any city, county, or consolidated local government.

(2) No agency or political subdivision of the state, other than the board, shall impose the following on individuals licensed under Sections 1 to 20 of this Act:

(a) A registration or licensing requirement; or

(b) A license fee to obtain any local license, except that this prohibition shall not prevent any local government from imposing an occupational license tax on any person operating as a home inspector within the jurisdiction of the local government.

SECTION 15. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

The board shall take disciplinary actions against or impose sanctions on a licensee for failing to comply with any provision of Sections 1 to 20 of this Act or any administrative regulations promulgated to carry out Sections 1 to 20 of this Act.

SECTION 16. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

(1) The procedures set forth in KRS Chapter 13B shall govern the board's conduct of disciplinary hearings.

(2) The board may summarily suspend a license for up to ninety (90) days before a final adjudication or during an appeal of the board's determination, if the board finds that the licensee would represent a clear and immediate danger to the public's health, safety, or property if allowed to perform home inspections. The summary suspension may be renewed upon a hearing before the board for up to ninety (90) days.

(3) If the board:

(a) Determines that an individual is not licensed under Sections 1 to 20 of this Act and is engaged in or believed to be engaged in activities for which a license is required under Sections 1 to 20 of this Act, the board shall issue an order to that individual requiring the individual to show cause why the individual should not be ordered to cease and desist from the activities. The show cause order shall set forth a date, time, and place for a hearing at

which the individual shall appear and show cause why the individual should not be subject to licensing under Sections 1 to 20 of this Act;

(b) After a hearing, determines that the activities in which the individual is engaged are subject to licensing under Sections 1 to 20 of this Act, the board may issue a cease and desist order that identifies the individual and describes activities that are the subject of the order.

(4) A cease and desist order issued under this section shall be enforceable in a Circuit Court of the Commonwealth.

SECTION 17. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

(1) An individual is guilty of a Class B misdemeanor under KRS 534.040 if the individual:

(a) Performs or offers to perform home inspections for compensation without being licensed as a home inspector and without being exempt from licensing;

(b) Presents as the individual's own the license of another;

(c) Intentionally gives false or materially misleading information to the board or to a board member in connection with a licensing matter;

(d) Impersonates another licensee; or

(e) Uses an expired, suspended, revoked, or an otherwise restricted license.

(2) When entering a judgment for a violation, the court shall add to any penalty imposed, the amount of any fee or other compensation earned by the individual in the commission of the violation.

(3) Each transaction involving unauthorized activities as described in this section, shall constitute a separate violation.

(4) In all actions for the collection of a fee or other compensation for performing home inspections, the party seeking relief shall allege and prove that, at the time



that the cause of action arose, the party seeking relief was not in violation of Section 7 of this Act.

- (5) The general counsel for the Department of Housing, Buildings and Construction shall act as the legal adviser for the board and provide any legal assistance necessary to carry out this section.

SECTION 18. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

- (1) An action for damages, whether brought in contract or tort, or on any other basis, based on professional services that were rendered or that should have been rendered by a licensed home inspector shall not be brought, commenced, or maintained unless the action is filed within one (1) year of the time that the claimant knew or should have known of a deficient inspection and damages and injuries resulting therefrom.
- (2) Nothing in this section creates any duty to a third party that is not available under common law.

SECTION 19. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

- (1) An individual who performs home inspections after the effective date of this Act, does not violate Sections 2 and 7 of this Act, and shall not be disciplined or sanctioned for failure to have a home inspector's license if the person obtains a home inspector's license not later than July 1, 2006.
- (2) Notwithstanding the requirements of Section 7 of this Act, the board may issue to an individual, upon the individual's application and payment of fees, a home inspector license if the individual:
- (a) Meets the requirements of Section 7 of this Act, excluding paragraph (2)(c) of Section 7 of this Act; or
- (b) Has been engaged in the practice of home inspections for at least one (1)

year prior to enactment of Sections 1 to 20 of this Act and documents the performance of at least twenty-five (25) home inspections performed for compensation in the previous twelve (12) months or at least one hundred (100) home inspections performed for compensation in the individual's career.

(3) The board may consider and accept the successful completion of equivalent licensing requirements in another state or local jurisdiction instead of one (1) or more of the requirements of Section 7 of this Act, if those requirements meet or exceed the requirements of Section 7 of this Act.

(4) This section shall expire January 1, 2007.

SECTION 20. A NEW SECTION OF KRS CHAPTER 198B IS CREATED TO READ AS FOLLOWS:

Home inspectors are prohibited from indicating in writing in the initial home inspection report, that any condition is not in compliance with any building code enforced under KRS Chapter 198B.

SECTION 21. A NEW SECTION OF KRS CHAPTER 21 IS CREATED TO READ AS FOLLOWS:

As used in Sections 21 to 27 of this Act, unless the context otherwise requires:

(1) "Action" means any civil lawsuit or action in contract or tort for damages or indemnity brought against a home inspector to assert a claim, whether by complaint, counterclaim, or cross-claim, for damages or the loss of use of real or personal property caused by a deficient home inspection or home inspection report regarding the inspection of a home. "Action" does not include any civil action in tort alleging personal injury or wrongful death to a person or persons resulting from a deficient home inspection or home inspection report;

(2) "Claimant" means a client who asserts a claim against a home inspector concerning a deficient home inspection or home inspection report regarding the

inspection of a home;

(3) "Home" means a structure consisting of at least one (1) but not more than four

(4) units, each designed for occupancy by a single family, whether the units are occupied or unoccupied;

(4) "Home inspector " means a person licensed in accordance with Sections 1 to 27 of this Act; and

(5) "Serve" or "service" means personal service or delivery by certified mail to the last known address of the addressee.

SECTION 22. A NEW SECTION OF KRS CHAPTER 411 IS CREATED TO READ AS FOLLOWS:

Sections 21 to 27 of this Act shall:

(1) Apply to any claim that arises before, on, or after July 15, 2004, as the result of a deficient home inspection or home inspection report regarding the inspection of a home, except a claim for personal injury or wrongful death, if the claim is the subject of an action commenced on or after July 15, 2004;

(2) Prevail over any conflicting law otherwise applicable to the claim or cause of action;

(3) Not bar or limit any claim or defense otherwise available except as otherwise provided in Sections 21 to 27 of this Act; and

(4) Not create a new theory upon which liability may be based.

SECTION 23. A NEW SECTION OF KRS CHAPTER 411 IS CREATED TO READ AS FOLLOWS:

In a claim to recover damages resulting from a deficient home inspection or home inspection report regarding the inspection of a home, a home inspector is liable for his or her acts or omissions or the acts or omissions of his or her agents or employees and is not liable for any damages caused by:

(1) The acts or omissions of a person other than the home inspector or his or her

agent or employee; or

- (2) Any construction defect disclosed to a claimant before his or her purchase of the home, if the disclosure was provided in writing and in language that is understandable and was signed by the claimant.

SECTION 24. A NEW SECTION OF KRS CHAPTER 411 IS CREATED TO READ AS FOLLOWS:

- (1) In every deficient home inspection or home inspection report action brought against a home inspector, the claimant shall serve written notice of claim on the home inspector. The notice of claim shall state that the claimant asserts a deficient home inspection or home inspection report claim against the home inspector and shall describe the claim in reasonable detail sufficient to determine the general nature of the deficiency.
- (2) Within twenty-one (21) days after service of the notice of claim, the home inspector shall serve a written response on the claimant by registered mail or personal service. The written response shall:
- (a) Propose to inspect the residence that is the subject of the claim and to complete the inspection within a specified time frame. The proposal shall include the statement that the home inspector shall, based on the inspection, offer to remedy the defect, compromise by payment, or dispute the claim;
- (b) Offer to compromise and settle the claim by monetary payment without inspection; or
- (c) State that the home inspector disputes the claim.
- (3) (a) If the home inspector disputes the claim or does not respond to the claimant's notice of claim within the time stated in subsection (2) of this section, then the claimant may bring an action against the home inspector for the claim described in the notice of claim without further notice.
- (b) If the claimant rejects the inspection proposal or the settlement offer made

by the home inspector pursuant to subsection (2) of this section, then the claimant shall serve written notice of the claimant's rejection on the home inspector. After service of the rejection, the claimant may bring an action against the home inspector for the deficient home inspection or home inspection report claim described in the notice of claim. If the home inspector has not received from the claimant, within thirty (30) days after the claimant's receipt of the home inspector's response, either an acceptance or a rejection of the inspection proposal or settlement offer, then at any time thereafter the home inspector may terminate the proposal or offer by serving written notice to the claimant, and the claimant may thereafter bring an action against the home inspector for the deficient home inspection or home inspection report claim described in the notice of claim.

(4) (a) If the claimant elects to allow the home inspector to inspect in accordance with the home inspector's proposal pursuant to subsection (2)(a) of this section, then the claimant shall provide the home inspector reasonable access to the claimant's home during normal working hours to inspect the premises.

(b) Within fourteen (14) days following completion of the inspection, the home inspector shall serve on the claimant:

1. A written offer to remedy the defect at no cost to the claimant, including a report of the scope of the inspection, the findings and results of the inspection, a description of the remedy necessary to cure the defect described in the claim, and a timetable for the completion of this remedy;
2. A written offer to compromise and settle the claim by monetary payment pursuant to subsection (2)(b) of this section; or
3. A written statement that the home inspector will not proceed further to

remedy the defect.

The claimant shall have the right to accept or reject the proposed remedy, or the monetary offer to settle the claim.

(c) If the home inspector does not proceed further to remedy the defect within the agreed timetable, or if the home inspector fails to comply with the provisions of paragraph (b) of this subsection, then the claimant may bring an action against the home inspector for the claim described in the notice of claim without further notice.

(d) If the claimant rejects the offer made by the home inspector pursuant to paragraph (b)1. or 2. of this subsection to either remedy the defect or to compromise and settle the claim by monetary payment, then the claimant shall serve written notice of the claimant's rejection on the home inspector. After service of the rejection notice, the claimant may bring an action against the home inspector for the deficient home inspection or home inspection report claim described in the notice of claim. If the home inspector has not received from the claimant, within thirty (30) days after the claimant's receipt of the home inspector's response, either an acceptance or a rejection of the offer made pursuant to paragraph (b)1. or 2. of this subsection, then at any time thereafter the home inspector may terminate the offer by serving written notice to the claimant.

(5) (a) Any claimant accepting the offer of a home inspector to remedy the defect pursuant to subsection (4)(b)1. of this section shall do so by serving the home inspector with a written notice of acceptance within a reasonable time period after receipt of the offer, and no later than thirty (30) days after receipt of the offer. The claimant shall provide the home inspector reasonable access to the claimant's home during normal working hours to perform and complete the remedy by the timetable stated in the offer.

- (b) The claimant and home inspector may, by written mutual agreement, alter the extent of remedy or the timetable, including but not limited to repair of additional defects.
- (6) If a claimant files a complaint, counterclaim, or cross-claim prior to meeting the requirements of this section, then the court may issue an order holding the action in abeyance until the parties comply with this section.
- (7) Nothing in this section may be construed to prevent a claimant from commencing an action on the deficient home inspection or home inspection report claim described in the notice of claim if the home inspector fails to perform the remedy agreed upon or fails to perform by the timetable agreed upon pursuant to subsection (2)(a) or (5) of this section.
- (8) The service of an amended notice of claim shall relate back to the original notice of claim for purposes of tolling statutes of limitations and repose.

SECTION 25. A NEW SECTION OF KRS CHAPTER 411 IS CREATED TO READ AS FOLLOWS:

- (1) The home inspector shall upon entering into a contract for the inspection of a building or residence, provide notice to each client, of the home inspector's right to offer to cure a deficient home inspection or home inspection report before a client may commence litigation against the home inspector. The notice shall be conspicuous and may be included as part of the underlying contract signed by the client.
- (2) The notice required by this section shall be in substantially the following form:
- "CHAPTER 411 OF THE KENTUCKY REVISED STATUTES CONTAIN IMPORTANT REQUIREMENTS YOU MUST FOLLOW BEFORE YOU MAY FILE A LAWSUIT FOR DEFECTIVE CONSTRUCTION AGAINST THE HOME INSPECTOR OF YOUR RESIDENCE. YOU MUST DELIVER TO YOUR HOME INSPECTOR A WRITTEN NOTICE OF ANY CONDITIONS

**YOU ALLEGE THAT YOUR HOME INSPECTOR FAILED TO INCLUDE IN THE HOME INSPECTION REPORT AND PROVIDE YOUR HOME INSPECTOR THE OPPORTUNITY TO MAKE AN OFFER TO REPAIR OR PAY FOR THE DEFECTS. YOU ARE NOT OBLIGATED TO ACCEPT ANY OFFER MADE BY THE HOME INSPECTOR. THERE ARE STRICT DEADLINES AND PROCEDURES UNDER STATE LAW, AND FAILURE TO FOLLOW THEM MAY AFFECT YOUR ABILITY TO FILE A LAWSUIT."**

- (3) Sections 21 to 27 of this Act shall not preclude or bar any action if notice is not given to the client as required by this section.**

SECTION 26. A NEW SECTION OF KRS CHAPTER 411 IS CREATED TO READ AS FOLLOWS:

- (1) Nothing in Sections 21 to 27 of this Act shall be construed to hinder or otherwise affect the employment, agency, or contractual relationship between and among homeowners and home inspectors during the process of inspection, and nothing in Sections 21 to 27 of this Act precludes the termination of those relationships as allowed under other law.**
- (2) Noncompliance by the client with Section 24 of this Act shall not operate as an affirmative defense in an action against a home inspector by the client for emergency repairs.**

SECTION 27. A NEW SECTION OF KRS CHAPTER 411 IS CREATED TO READ AS FOLLOWS:

**If a written notice of claim is served under Section 24 of this Act, then the statute of limitation for the underlying action is tolled until seventy-five (75) days after the expiration of the time frame agreed to by the parties under subsection (2) of Section 24 of this Act, or the date established for inspection pursuant to paragraph (a) of subsection (2) of Section 24 of this Act, or the expiration of the time frame contained in paragraph (b) of subsection (4) of Section 24 of this Act, whichever occurs later.**



Section 28. KRS 198B.030 is amended to read as follows:

- (1) There is hereby created the Kentucky department of housing, buildings and construction within the cabinet for public protection and regulation. The governor shall appoint a commissioner to head the department by July 1, 1978. The commissioner shall receive for his services such compensation as the governor shall determine.
- (2) The commissioner may employ sufficient staff to carry out the functions of his office. Neither the commissioner nor any member of his staff shall be employed, either directly or indirectly, in any aspect of the building industry as regulated by this chapter while employed by the department of housing, buildings and construction.
- (3) The department shall serve as staff for the board of housing, buildings and construction as established by this chapter, and shall perform all budgeting, procurement, and other administrative activities necessary to the functioning of this body. The board shall prescribe the duties of the commissioner in addition to those duties otherwise delegated to him by the governor or prescribed for him by law.
- (4) The department may enter into contracts with the federal government, other agencies of state government or with its subdivisions, or with private profit or nonprofit organizations in order to effect the purposes of this chapter.
- (5) Subject to the direction of the board of housing, buildings and construction, the commissioner shall cooperate with the agencies of the United States and with the governing bodies and housing authorities of counties, cities, and with not for profit organizations and area development districts in relation to matters set forth in this chapter, and in any reasonable manner that may be necessary for the state to qualify for, and to receive grants or aid from such agencies. To these ends and subject to the direction of the board, the commissioner shall have the power to comply with each condition and execute such agreements as may be necessary, convenient, or

desirable.

- (6) Nothing in this chapter shall preclude any other agency, board, or officer of the state from being designated as the directing or allocating agency, board, or officer for the distribution of federal grants and aid, or the performance of other duties to the extent necessary to qualify for and to receive grants and aid for programs under the administration of the department.
- (7) The commissioner is authorized to receive, for and on behalf of the state, the department, and the board of housing, buildings and construction, from the United States and agencies thereof, and from any and all other sources, grants and aid and gifts made for the purpose of providing, or to assist in providing, any of the programs authorized by this chapter, including expenses of administration. All such funds shall be paid into the state treasury and credited to a trust and agency fund to be used by the department in carrying out the provisions of this chapter. No part of this fund shall revert to the general fund of the Commonwealth.
- (8) The Kentucky Board of Home Inspectors established in Section 3 of this Act shall be attached to the department for administrative purposes.**

AN ACT relating to security interests.

***Be it enacted by the General Assembly of the Commonwealth of Kentucky:***

Section 1. KRS 186.045 is amended to read as follows:

- (1) A perfected security interest in a motor vehicle that has been satisfied by payment in full shall be deemed to have been discharged if one (1) or both of the following events has occurred:
  - (a) The funds to pay in full and discharge the security interest have been provided to the secured party in the form of a cashier's check, certified check, or wire transfer; or
  - (b) The debt has been paid to a secured party who is no longer in existence or has failed to file the necessary documents to discharge the lien.
- (2) If payment in full has been made under subsection (1)(a) of this section, the discharge of the lien shall be made not later than ten (10) days from the receipt of the payment.
- (3) When a security interest has been paid in full and a termination statement or discharge has not been filed, the debtor may petition the Circuit Court in the county of the debtor's residence to order the discharge of the security interest. The debtor shall present written evidence to the Circuit Court that the security interest has been paid in full. If the evidence presented to the Circuit Court proves to the court's satisfaction that the security interest has been paid in full, the court shall order the county clerk to note the termination on the title and to remove the lien from the Automated Vehicle Information System (AVIS). A copy of the court's order shall immediately be sent to the county clerk in the county where the security interest was originally filed and the county clerk shall discharge the security interest and remove the lien information from AVIS in accordance with the provisions of this section.
- (4) Whenever a security interest has been discharged, other than by proceedings under Part 6 of Article 9 of KRS Chapter 355 or similar proceedings, the secured party

shall deliver an authenticated<sup>[a]</sup> termination statement in the manner required by KRS 355.9-513 and 186A.195 to the county clerk of the county in which the title lien statement was submitted. The secured party shall also deliver a copy of the termination statement to the debtor or the debtor's transferee. For failure to file the termination statement within the allowable time, the secured party shall be subject to the penalty provided in KRS 186.990(1). Except as provided in subsection (3) of this section, within five (5) days after the receipt of such documents, the county clerk shall note the filing in the index, in language prescribed by the cabinet, that the termination statement has been filed. Upon presentation of the owner's title showing a security interest to the county clerk where the termination statement was submitted, and with the copy of the termination statement submitted by the secured party, the clerk shall discharge the security interest by noting on the title that the termination statement has been filed and place the seal of the county clerk thereon. The clerk shall return the owner's title to the owner. The county clerk shall then file the termination statement in the place from which the title lien statement was removed. Termination statements shall be retained in the clerk's files for a period of two (2) years subsequent to the date of filing a statement, at which time they may be destroyed. The fee for these services are included in the provisions of KRS 186A.190.

- (5) Upon presentation of an owner's title showing a security interest to the county clerk of a county where the termination statement was not delivered, the county clerk shall access the automated system to determine whether a record of termination of the security interest has been entered into the automated system by the county clerk where the termination statement was delivered by the secured party as provided in KRS 186A.210. If a record of termination has been entered into the automated system, the county clerk of the county where the termination statement was not delivered, shall note the discharge of the security interest on the certificate of title

by noting that the termination statement has been delivered, the county where it was delivered, and placing the seal of the county clerk thereon and may rely on the automated system to do so. If a record of termination has not been entered into the automated system, the county clerk of the county other than where the termination statement was delivered shall not make any notation upon the certificate of title that the security interest has been discharged or that a termination statement has been delivered to the county where the title lien statement was submitted.

- (6) Whenever any secured party repossesses a vehicle titled in Kentucky, for which a security interest is in existence at the time of repossession, and disposes of the vehicle pursuant to the provisions of KRS Chapter 355, he shall present, within fifteen (15) days after such disposition, an affidavit in a form prescribed by the department and a termination statement or proof that a termination statement has been filed. The new owner shall pay all applicable fees for titling and transferring the vehicle to the county clerk. Upon receipt of such documents, the county clerk who issued the lien shall then omit from the title he makes application for any information relating to the security interest under which the vehicle was repossessed or any security interest subordinate thereto. However, any security interest, as shown by such title which is superior to the one under which the vehicle was repossessed, shall be shown on the title issued by the clerk unless the prior secured party has discharged the security interest in the clerk's office or proof of termination is submitted, if the prior security interest was discharged in another clerk's office.
- (7) Whenever any vehicle brought into Kentucky is required to be titled and the vehicle is then subject to a security interest in another state as shown by the out-of-state documents presented to the clerk, the county clerk is prohibited from processing the application for title on the vehicle unless the owner obtains from the secured party a financing statement or title lien statement and presents same to the clerk along with the fees required in KRS 186A.190. The clerk shall note the out-of-state security

interest on the certificate of title. This provision does not apply to vehicles required to be registered in Kentucky under forced registration provisions under KRS 186.145.

- (8) The fees provided for in this section are in addition to any state fee provided for by law.
- (9) Any person violating any provision of this section or any person refusing to surrender a certificate of title registration and ownership or transfer certificate upon request of any person entitled thereto, is subject to the penalties provided in subsection (1) of KRS 186.990.
- (10) The county clerk is prohibited from noting any security interest on a certificate of title on any vehicle subject to the provisions of KRS Chapter 186A if a certificate of title therefor is presented to him which has all the spaces provided thereon for noting security interests fully exhausted. The owner is responsible for ensuring that a discharge is noted on the certificate of title for each security interest and then a duplicate title as provided for in KRS 186A.180 shall be obtained from the clerk by the owner of the vehicle.
- (11) Security interests in vehicles sold to or owned by residents of other states shall be perfected in the state of the nonresident and repossession of the vehicle shall be taken pursuant to the laws of that state, unless:
  - (a) The vehicle is principally operated in Kentucky;
  - (b) The vehicle is properly titled in Kentucky under KRS Chapter 186A; and
  - (c) The security interest is authorized to be noted on the certificate of title by the county clerk under KRS Chapter 186A.

AN ACT relating to certificates of deposit.

*Be it enacted by the General Assembly of the Commonwealth of Kentucky:*

SECTION 1. A NEW SECTION OF KRS CHAPTER 367 IS CREATED TO READ AS FOLLOWS:

- (1) As used in this section, "financial institution" means a bank, trust company, savings and loan association, or credit union authorized by law to do business in this state.
- (2) (a) A financial institution that issues a certificate of deposit that is subject to automatic renewal at maturity shall, upon automatic renewal, renew the certificate of deposit for a like term at the best available rate of interest as posted at the issuing financial institution for similarly issued certificates of like term.
- (b) Any notice sent by the financial institution to the holder of a certificate of deposit subject to automatic renewal prior to maturity which notifies the holder of the holder's options upon renewal shall disclose that if the certificate of deposit automatically renews it will be renewed for a like term at the best available rate of interest as posted at the issuing financial institution for similarly issued certificates of like term.
- (3) (a) Any violation of this section shall be an unfair, false, misleading, and deceptive act or practice in the conduct of trade or commerce in violation of KRS 367.170.
- (b) All of the remedies, powers, and duties provided for the Attorney General in KRS 367.190 to 367.300, and all of the penalties provided in KRS 367.990, pertaining to acts declared unlawful by KRS 367.170, shall apply to acts and practices declared unlawful in this section.





# **ANNUAL CASE LAW UPDATE FOR BANK COUNSEL**

*M. Thurman Senn  
Morgan & Pottinger, P.S.C.  
Louisville, Kentucky*

Copyright 2004. M. Thurman Senn. All Rights Reserved.

**SECTION B**

# Case Law Update

24th Annual Conference On  
Legal Issues For Financial Institutions  
April 16, 2004

M. THURMAN SENN

Morgan & Pottinger, P.S.C.  
601 W. Main Street  
Louisville, KY 40202  
(502) 589-2780  
mts@morganandpottinger.com

©2004 M. Thurman Senn

All rights reserved

This outline is designed to provide general information on the subject matters covered. It is not intended to provide either a complete survey of all possible developments or a comprehensive explanation or analysis of those developments mentioned. Readers should consult the original source materials referenced. Furthermore, this outline is not intended nor should it be used as a substitute for specific legal advice or opinion. Finally, this outline is published with the understanding that the publisher is not engaged in rendering legal service.

Note: The author is currently, or in the future may be, engaged in representing clients in lawsuits and other proceedings which directly involve some or all of the materials set forth in this outline. No statements contained herein or any statements made by the author during his presentation should be construed as the position of those clients for purposes of those proceedings. Nor should such statements be construed as precluding the author from advocating any position on behalf of those or other clients.

## ANNUAL CASE LAW UPDATE FOR BANK COUNSEL

I.	LAWYERS AT REAL ESTATE CLOSINGS .....	B-1
II.	TAXATION - <u>ILLINOIS TOOL WORKS</u> AND ITS PROGENY .....	B-1
III.	FORGED ENDORSEMENTS .....	B-3
IV.	TRUTH IN LENDING ACT .....	B-3
V.	GUARANTY AGREEMENTS (KRS 371.065) .....	B-4
VI.	PUNITIVE DAMAGES .....	B-4
VII.	FAIR DEBT COLLECTION PRACTICES ACT .....	B-4
VIII.	STATUTES OF LIMITATION .....	B-5
IX.	BANK "TYING" .....	B-5
X.	ARBITRATION .....	B-6
XI.	PERSONAL LIABILITY FOR "TRUST FUND" TAXES .....	B-6
XII.	DOING BUSINESS AND PRACTICING LAW IN THE INTERNET AGE .....	B-6
XIII.	COVENANTS NOT TO COMPETE .....	B-7
XIV.	SETTLEMENT AGREEMENTS .....	B-7
XV.	FAMILY AND MEDICAL LEAVE ACT .....	B-8
XVI.	RECOVERY OF ATTORNEYS' FEES .....	B-8
XVII.	LENDING TO COMPETITORS OF LOAN CUSTOMERS .....	B-9
XVIII.	MAJOR TRENDS AND ISSUES IN OTHER JURISDICTIONS .....	B-9
APPENDIX:	AMERICAN BANKERS ASSOCIATION'S "STATUS OF IMPORTANT BANKING CASES" (4/1/04) .....	B-11

### SECTION B



## Case Law Update

### I. **Lawyers At Real Estate Closings – Countrywide Home Loans, Inc., et al. v. Kentucky Bar Association, 113 S.W.3d. 105 (Ky., 8/21/03).**

A. Kentucky Bar Association's ("KBA") U-58 is vacated and reaffirming that KBA's "U-31 accurately described the unauthorized practice of law parameters for real estate closings."

B. In U-58, the Kentucky Bar Association generally took the position that the performance of a real estate closing by a lay closing agent is the unauthorized practice of law.

C. In U-31, the KBA generally permitted laypersons to conduct real estate closings so long as they avoided giving legal advice.

D. Kentucky Supreme Court actually permitted discovery on the issue and 16 depositions were taken and over 1000 pages of exhibits tendered.

E. A "closing" was understood by the Kentucky Supreme Court to be "the final steps of the transaction whereat the consideration is paid, mortgage is secured, deed is delivered or placed in escrow, etc." The Kentucky Supreme Court noted that it was comfortable with this ministerial view "because most of the closing documents are prepared by the lender and legal issues are almost always resolved prior to the closing."

F. The Kentucky Supreme Court believed that "safeguards [are] in place to protect the public" in lay closings in the form of (1) the economic incentives on the closing parties to provide quality in order to earn repeat business and avoid lawsuits; and (2) the general requirement of title insurance underwriters that closing agents obtain E&O insurance; and (3) the existence of title insurance for the owners; and (4) civil actions for damages for improper service.

G. "Although we recognize that persons with the financial wherewithal to do so may wish to retain independent counsel for a real estate closing, we also recognize that for us to require parties to have independent counsel would substantially increase the transactional costs associated with a home purchase and thus run contrary to the public interest."

H. Certain aspects of the residential real estate transaction were recognized as constituting the practice of law: (1) "the title commitment letter" and (2) preparation of deed and mortgages."

### II. **Taxation – Illinois Tool Works And Its Progeny:**

#### A. Background Generally.

1. Historically, as part of their license tax liability calculations, companies paying taxes in Kentucky must include the amount of stock owned in subsidiary companies. In addition, prior to 1976, Kentucky law required corporations domiciled, or headquartered, within the state to pay license tax on the holding corporation, including stock owned in any subsidiaries. In 1976, the Kentucky legislature recognized this as double taxation and enacted KRS 136.071, which provided Kentucky domiciled companies with a deduction in this calculation. This deduction has been viewed by business development organizations as a valuable economic development tool for Kentucky, designed to encourage businesses to headquarter here and expand.

B. The Illinois Tool Works Decision.

1. On December 5, 2002, the Franklin Circuit Court in Illinois Tool Works v. Kentucky Revenue Cabinet declared the corporate license tax deduction available to in-state holding corporations unconstitutional -- essentially reinstating this double taxation for Kentucky companies. The ruling claimed Kentucky tax law provided in-state corporations with preferential treatment.

2. The Circuit Court ordered refunds to be paid to out-of-state holding companies that had not previously been eligible for the deduction. It also ruled that the tax benefits will no longer be available to any company, foreign or domestic, beginning in the 2004 tax year.

C. Impact Of The Decision Generally And Upon Banking In Particular.

1. Major chambers of commerce, trade associations, and business development organizations are concerned about the impact of the decision. They have argued that within the year, Kentucky will see its most profitable businesses moving assets to other states such as Ohio, where holding companies are not subject to franchise tax; Tennessee, where parent companies are given a deduction for subsidiaries; and Indiana, which does not even have a corporate license tax. They argue that if physical facilities follow, hundreds of thousands of job will be lost. They argue that legislation addressing the decision is necessary to prevent double taxation of holding companies in order to encourage Kentucky-based companies to stay in the state and to encourage out-of-state companies to relocate here.

2. Impacts On Bank Holding Companies.

a. The banking industry generally contends that the ruling would result in a particularly hard hit for Kentucky financial institutions because of their unique tax structure, designed through the Bank Franchise Tax—a tax that was to be paid ‘in lieu of other taxes.’

b. The Bank Franchise Tax takes into account surplus; capital stock paid in; undivided profit and capital reserve; net unrealized holding gains or losses on available for sale securities; cumulative foreign currency translation adjustments and equity related to investment in subsidiaries (net capital). The Bank Franchise Tax was designed after the banking industry and the Kentucky Revenue Cabinet negotiated in 1996 to develop a new ‘tax neutral’ structure, in lieu of all other corporate taxes, for the banking industry as a whole. The assumption of the banking industry, and as stated in the statute, was that the general corporate license tax (imposed by 136.071) would not apply to banks.

c. The Illinois Tool decision is perceived to result in essentially a double tax on banks because of the way bank stock is held. Most banks are operated in a holding company structure, and the holding company often has no assets or operational purpose other than to hold the stock of the subsidiary bank. If you remove the bank subsidiary deduction, the license tax on the bank holding company becomes just a tax on the bank stock. But, because the bank is already taxed, this is considered inequitable and not in spirit with the assurances made when the bank franchise tax was passed.

D. The Governor's Veto Of Legislation To Address The Decision.

1. A proposal to address this problem was developed by the business community with assistance from state revenue officials. The proposal allowed in-state holding

companies to keep most of the deduction (90 percent), with the remainder used to cover the cost of extending that same level of deduction to out of state corporations with operations in Kentucky. The proposal was intended to address the Franklin Circuit Court's objection to the inconsistent treatment of in-state and out-of-state corporations while having no adverse impact on state revenues.

2. The proposal included as part of House Bill 390 during the 2003 legislative session. Although HB 390 was passed, on April 3, 2003, Governor Patton vetoed the provisions relating to the Illinois Tool amendment. The veto occurred after the General Assembly had adjourned, leaving no opportunity for the veto to be overridden.

E. The Challenge To The Governor's Veto – Citizens National Corp. v. Mayton, Franklin Circuit Court, No. 03-CI-917.

1. In 1993, Citizens National Corporation, Humana, Inc., Kindred Healthcare, Inc., LG&E Energy Corp., and Yum! Brands, filed a lawsuit challenging the constitutionality of Governor Patton's line-item veto of the Illinois Tool.

2. The lawsuit is currently pending.

III. **Forged Endorsements** – John Hancock Financial Services, Inc. v. Old Kent Bank, 346 F.3d 727 (6<sup>th</sup> Cir. 10/10/03).

1. Clients of securities firm, John Hancock Financial Services, Inc. ("John Hancock"), delivered to their broker at John Hancock, Patrick Sherman, checks payable to the order of the securities firm. Broker endorsed the check with a stamp that read: "Sherman and Associates Financial Services". Broker had opened a checking account in that name at Old Kent Bank, and the bank permitted the deposit. Over 7 years, this occurred on approximately 71 checks totaling in excess of \$800,000. Broker hid the fraud by generating false statements for his clients.

2. Applying Michigan law, the Sixth Circuit held that an indorsement by a wrongdoer that is "completely different from the [named] payee's]" is not "the making of a forged signature on an instrument" within the meaning of UCC §3-406 so as to allow the depository bank to argue the comparative fault provisions of UCC §3-406.

3. The fault allocation rules of Articles 3 and 4 of the Uniform Commercial Code relating to negotiable instruments displace common law rules of negligence thereby preventing the depository bank from relying upon the general comparative fault provisions of the Michigan Tort Reform Act.

4. Payee's claims for checks deposited more than 3 years before the parties' statute of limitations tolling agreement were barred by the applicable Michigan statute of limitations.

5. Except as barred by the statute of limitations, depository bank was liable for conversion under UCC §3-420 for \$404,217.44 plus interest.

IV. **Truth In Lending Act** -- Household Credit Services v. Pfennig, U.S. Supreme Court, Docket No. 02-857.

1. U.S. Supreme Court has granted certiorari to review a decision of the Sixth Circuit concerning the proper method for disclosing an "over-limit" fee in a open-end credit card account. Expressing the opinion that the charge fell within the statutory definition of "finance charge", the

Sixth Circuit declined to follow a provision of Regulation Z which excluded from the definition of "finance charge" those "[c]harges for actual unanticipated late payment, for exceeding a credit limit, or for delinquency, default, or a similar occurrence."

2. This case has the potential for being an important decision on the extent to which Court should defer to the Federal Reserve Board's Regulation Z as the proper application of the statutory provisions of the federal Truth In Lending Act.

V. **Guaranty Agreements (KRS 371.065)** – Wheeler & Clevenger Oil Co. v. Washburn, 2001-SC-0271 (2/19/04) (to be published).

1. President of HICO Transport, Inc. signed a credit application submitted to Wheeler & Clevenger Oil Co. as a personal guarantor in two places. Credit application was for a line of credit to purchase fuel and other merchandise. Guaranty language did not contain a maximum indebtedness or a termination date. When oil company brought suit, guarantor defended on the ground that the guaranty violated KRS 371.065.

2. Trial court and Court of Appeals ruled in favor of guarantor.

3. Kentucky Supreme Court reversed.

a. Because of the title of the 1990 act amending KRS 371.065, Court first ruled that KRS 371.065 applies to "all guaranties" not just "guaranties of commercial paper."

b. Although the statute applies, there is no need for a maximum indebtedness or termination date if the guaranty is either "written on" or "expressly refer[s] to, the instrument or instruments being guaranteed."

c. In this case, the exception applies because "the guaranty agreement is found on the document being guaranteed."

d. Purpose of the statute "is a consumer-protection provision designed to protect the guarantor by reducing the risk of a guarantor agreeing to guarantee an unknown obligation."

VI. **Punitive Damages** – Phelps v. Louisville Water Co., Ky., 103 S.W.3d 46 (4/24/03).

1. Suit by the estates of two motorists who were killed when their car crashed into a flatbed trailer parked at construction site of Louisville Water Company. Jury awarded \$176,361 in compensatory damages (55% allocated to the water company) and \$2,000,000 in punitive damages against the water company.

2. Supreme Court states that it is "required to conduct a de novo review of the trial court's determination that the award was not so grossly excessive as to violate due process." Court also applied the "result of passion and prejudice" analysis under traditional Kentucky common law.

3. Court upheld the punitive damages award.

VII. **Fair Debt Collection Practices Act** – Montgomery v. Huntington Bank, 350 F.3d 558 (6<sup>th</sup> Cir. 10/9/03).

1. Son of debtor sued creditor that had taken a security interest in his mother's motor



vehicle and the repo agent for alleged damages incurred when the vehicle was repossessed.

2. Although the son was not the "consumer" in the transaction because he was not liable for the debt, he still had standing to allege violations of (a) 15 U.S.C. §1692d which prohibits a debt collector from using "any conduct the natural consequence of which is to harass, oppress, or abuse any person in connection with the collection of a debt" and (b) 15 U.S.C. §1692e which prohibits a debt collector from using "any false, deceptive, or misleading representation or means in connection with the collection of any debt."

3. The son could allege a civil action for relief because 15 U.S.C. §1692k(a) imposes liability upon "a debt collector who fails to comply with any provision of this subchapter with respect to any person is liable to such person...."

4. However, neither Huntington Bank nor the repo agent were a "debt collector."

a. Huntington Bank was not because it fell within the exception of 15 U.S.C. §1692a(6)(F)(ii) and also (F)(iii) because it was the original creditor on the loan.

B. The repo agent was not because it, as the enforcer of a security interest, is generally is not a debt collector under an express provision of 15 U.S.C. §1692a(6). However, the enforcer of a security interest has potential liability under 15 U.S.C. §1692f(6) if there is no present right to possession of the collateral through an enforceable security interest. Since the son did not allege a violation of §1692f(6), the son had no claim against the repo agent.

**VIII. Statutes Of Limitation -- Barnes v. Community Trust Bank, Ky.App., 121 S.W.3d 520 (11/7/03).**

1. An action to recover for a breach of a motor vehicle retail installment sales contract under KRS Chapter190 is governed by the 4-year statute of limitations in KRS 355.2-725 and not the 15-year contract statute of limitations under KRS 413.090.

**IX. Bank "Tying" – Highland Capital, Inc. v. Franklin National Bank, 350 F.3d 558 (6<sup>th</sup> Cir. 11/25/03).**

1. Plaintiff alleged that Defendant, Frank National Bank, violated the "anti-tying" provisions of the federal Bank Holding Company Act, 12 U.S.C. §1972, by alleging that the bank conditioned approval of a \$610,000 loan to refinance a real estate loan on the borrower's purchase of 69,400 shares of the stock of the bank's holding company.

2. Although there was no document imposing this condition, borrower claimed that alleged irregularities in processing the loan, the lack of solid information about the creditworthiness of the borrower, and other evidence that the loan would not have been made in the normal course of banking practice, was circumstantial evidence of an improper "tying". Bank presented affidavits expressly denying that the stock purchase was a condition for making the loan.

3. The plaintiff in a bank tying lawsuit "must prove that the purchase of the tied product or service was a mandatory condition or requirement of obtaining a loan from the lender." The plaintiff does not need to prove "force or coercion" by the bank.

4. In this case, the plaintiff's circumstantial evidence reached only the level of "speculation and conjecture" aid not establish a genuine issue that the loan was conditioned upon

purchase of the holding company stock.

**X. Arbitration:**

1. Wilder v. Absorption Corp., Ky., 107 S.W.2d 181 (2003)

a. Dispute between manufacturer of specialty pet car products headquartered in Washington and its sale representatives located in Boone County, Kentucky having the states of Michigan, Indiana, Ohio and Kentucky as their territory.

a. Provision in arbitration agreement requiring arbitration in Washington was so inconvenient and unreasonable as to be unenforceable. Parties ordered to submit to arbitration in Kentucky.

2. Larry A. Judd, et al. v. Paul J. Sinnott, et al., Kentucky Supreme Court, 2002-SC-939-D (case pending).

a. Whether fraud in the inducement generally is a basis to avoid an arbitration agreement or whether fraud in the inducement of the arbitration clause specifically is required.

**XI. Personal Liability For "Trust Fund" Taxes – Bell v. United States, 33 SCR 3 at p. 29 (6<sup>th</sup> Cir. 1/7/04).**

1. Chief shareholder and principal officer of company was personally responsible under §6672 of the Internal Revenue Code for failing to deliver employee withholding taxes to the IRS despite lender's refusal to approve using funds in a loan lock-box arrangement to pay previously accrued and delinquent payroll trust taxes.

2. Corporate officer could not claim that lender's refusal prevented his actions from being "willful."

3. Corporation's decision to enter into loan agreement with lender was voluntary and not a justification. Corporate officer's options were to "have shut down the company, suspended operations, filed for bankruptcy, applied for a bridge loan from another lender, or simply violated the contract with Bank One instead of failing to fulfill his tax debt."

**XII. Doing Business And Practicing Law In The Internet Age.**

1. Issue: "Is it ethical not to meet face-to-face with your client if you communicate by e-mail or telephone instead?"

a. "There is no *per se* requirement that an attorney actually be in the physical presence of his client to provide competent legal services... The attorney may ethically use electronic forms of communication in working with clients so long as all necessary information is transmitted between the attorney and the client ... [and] the content and caliber of those services otherwise comport with the duties of competence and communication." Virginia Legal Ethics Opinion 1791 (March 2004).

2. "Cybersquatting" – Lucas Nursery and Landscaping, Inc. v. Gross, 359 F.3d 806 6<sup>th</sup> Cir. 03/05/04).

a. Customer of nursery did not violate that Anticybersquatting Consumer Protection Act, 15 U.S.C. § 1125(d)(1)(A) (2000) ("the ACPA"), by registering the domain name "lucasnursery.com" and creating a web site on which she detailed her complaints against Lucas Nursery and Landscaping, Inc. for its allegedly bad service in landscaping her front yard.

b. Pursuant to the ACPA, a cybersquatter is potentially liable to the owner of a protected mark if that person:

(i) has a bad faith intent to profit from the mark . . . ; and

(ii) registers, traffics in, or uses a domain name that --

(I) in the case of a mark that is distinctive . . . , is identical or confusingly similar to that mark;

(II) in the case of a famous mark . . . , is identical or confusingly similar to or dilutive of that mark; or

(III) is a trademark, word, or name protected by reason of section 706 of Title 18 or section 220506 of Title 36.

15 U.S.C. § 1125(d)(1)(A).

c. Customer did not violate the ACPA because she was not acting in "bad faith" but was merely attempting to publicize her dissatisfaction. Determination of "bad faith" under the ACPA is a facts and circumstances test applying a number of judicially established factors.

**XIII. Covenants Not To Compete – United Rentals (North America), Inc. v. Keizer, 355 F.3d 399 (6<sup>th</sup> Cir. 1/7/04).**

1. Under Michigan law, when new employer did not have a physical office in the Target Area, former employee did not violate provision of non-compete agreement which restricted him from "anywhere in the Target Area (as herein defined), directly or indirectly, acting individually or as the owner, shareholder, partner, or employee of any entity . . . [which] engage[s] in the operation of any equipment sale, rental or leasing business."

2. Fact that new employer sold to customers located in the Target Area was not sufficient to establish a violation.

3. Court contrasted language of the agreement with one in which the employee agreed not to "solicit or take orders for or sell or deliver any such merchandise" in the prohibited area.

4. An important factor was that the agreement was drafted by the employer and, therefore, would be construed against the employer.

5. Court also affirmed dismissal of claims of violation of confidentiality obligations were the former employer presented no evidence of a real misappropriation of confidential information. Fact that new employer briefly saw former employer's customer list was not sufficient when the new employer did not use and instead discarded the list.

6. Practice pointer: define in as many ways as possible what constituted an impermissible competing activity.

**XIV. Settlement Agreements.**

1. Frear v. P.T.A. Industries, Inc., Ky., 103 S.W.3d 99 (4/24/03).

a. Dispute over terms of parties' oral agreement to settle. When it came time to draft a formal settlement agreement, the parties reached an impasse over release and indemnification terms.

b. Court relied upon lawyer's confirming letter as accurately stating the agreement to provide a release. Since the lawyer's letter did not mention any indemnity obligation, none was required in order to obtain settlement payment.

2. Hidrofiltros v. Rexair, Inc., 355 F.3d 927 (6<sup>th</sup> Cir. 11/6/04).

a. A provision in a settlement agreement that provided that the federal District Court retained "exclusive" jurisdiction over the parties "for purposes of enforcing the settlement agreement" did not preclude a settling party from bring an action in Portugal against a corporate affiliate of the settling parties concerning an alleged violation of Portugese trademark law.

b. The Portugese lawsuit was not to recover damages from any settling party or to force compliance with the settlement agreement despite the assertion that the settlement agreement was intended to establish the Michigan District Court as the exclusive venue for future trademark disputes.

c. The Court explained that "had the parties' intended to place additional restrictions upon Rexair's right to pursue legal remedies, they certainly could have drafted their settlement agreement accordingly."

**XV. Family And Medical Leave Act:**

1. Cavin v. Honda Of America Mfg., Inc., 346 F.3d 713 (6<sup>th</sup> Cir. 10/10/03). Enforcing a FMLA regulation at 29 C.F.R. §825.302(d) which provides that an employer cannot deny FMLA leave for failure to comply with an internal notice requirement so long as the employee "gives timely verbal or other notice" which complies with the FMLA's requirements.

2. Arban v. West Publishing Corp., 345 F.3d 390 (6<sup>th</sup> Cir. 9/24/03). Affirming jury verdict in favor of employee alleging denial of FMLA reinstatement rights and retaliatory discharge for exercising FMLA rights. Employee's relief can include "front pay" if the employee does not seek reinstatement because he or she has found alternative work during the period of litigation. District Court abused its discretion in denying statutory liquidated damages to the employee when the jury found the employer violated the FMLA by making a pretext discharge.

**XVI. Recovery Of Attorneys' Fees -- Tomeo v. Rubarts, et al., 2002-CA-002464 (Ky.App. 12/5/03) (unpublished).**

1. When a creditor is faced with counterclaim raised by debtors attempting to avoid collection of a debt, is the cost of successfully defending the debtors' counterclaim recoverable under an attorneys' fee provision allowing recovery of fees "incurred by [the creditor] for the enforcement of this note or the lien securing this note"?

2. In a recent unpublished opinion, the Kentucky Court of Appeals said "yes" but only after applying a four-factor test established in a 1988 District of Columbia decision, Kudon v. F.M.E. Corp., 547 A.2d 976 (D.C.App. 1988).

3. It appears that the Court of Appeals would not have had to apply this test if the

attorneys' fee provision had been drafted more broadly. Keep this in mind when drafting attorneys' fees provisions in your contracts.

**XVII. Lending To Competitors Of Loan Customers -- Read & Lundy, Inc. v. The Washington Trust Co., 2004 WL 41714 (R.I. 1/9/04).**

1. Lender loans money to CSI, a competitor of R&L. CSI is owned by a former employee of R&L and that employee's accountant. Former employee had previously attempted to buy R&L, and Lender had been involved in attempted funding of the purchase.

2. R&L sued Lender alleging that Lender was improperly aiding CSI and improperly using information about R&L that the Lender obtained in connection with the unsuccessful purchase attempt. R&L alleged breach of contract, improper interference with contractual relations, civil conspiracy and violation of the Uniform Trade Secrets Act.

3. Rhode Island Supreme Court affirmed ruling in favor of the Lender. On the issue of breach of contract, the Supreme Court wrote that "there was no evidence that the parties ever considered what would happen to plaintiffs' financial information after they provided it to the bank, much less that the parties mutually agreed it would not be used by the bank beyond consideration of Bibeau's loan application." The Court held that absent an agreement, nothing prohibited the Bank's use of information supplied by plaintiffs to consider CSI's loan application.

4. In contrast, the Kentucky Supreme Court in Steelvest, Inc. v. Scansteel Service Center, Inc., Ky., 807 S.W.2d 476, 486 (1991), reversed a grant of summary judgment in favor of a lender that lent money to establish a business that competed with another loan customer of the bank. The Kentucky Supreme Court held that genuine issues of material fact existed on the competitor's claim that the lender "improperly used and relied upon certain information concerning [customer #1] obtained from [an owner of customer #1] when it proceeded to finance [customer #2]."

5. Practice Pointers:

a. Include provisions in your bank's loan application and loan documents relating to permissible uses of information supplied to the bank by a business loan applicant or a loan customer. Make sure it is consistent with your GLBA privacy notices.

b. Do not use information supplied by or concerning a customer for any purpose other than dealing with that customer unless you have the customer's agreement to do so.

**XVIII. Major Trends And Issues In Other Jurisdictions.**





1120 Connecticut Avenue, NW  
Washington, DC 20036

1-800-BANKERS  
www.aba.com

OFFICE OF THE GENERAL COUNSEL  
STATUS OF IMPORTANT BANKING CASES

April 1, 2004

\*\*\*\*\*

NEW THIS MONTH:

- \* Disclosure of nonpublic personal information OK in judicial proceedings. (¶ 22)
- \* ABA et al. file amici brief in Massachusetts insurance regulation case. (¶ 23)
- \* ABA and Illinois Bankers file brief in Consumer Fraud Act case. (¶ 29)

---

© 2004 American Bankers Association. Not-for-profit reproduction is authorized without prior permission provided that the source is credited.

New cases and cases in which there have been significant developments since the last monthly report are marked \*.

## ANTITRUST

1. United States v. Visa, U.S.A. (2d Cir. Nos. 02-6074, -6076, -6078). On October 7, 1998, Justice Department filed antitrust suit against Visa and Mastercard challenging the "rules" of both networks prohibiting their respective member banks from offering credit cards that compete with those two. The rules allegedly have the effect of eliminating real competition between Visa and Mastercard and hampering competition or potential competition from other networks. On October 9, 2001, court held that "duality" rules, by which thousands of banks can and do issue both Visa and Master Card, are not anticompetitive, but the prohibition against Visa and/or Master Card member banks also issuing American Express and/or Discover cards is an antitrust violation (163 F. Supp. 2d 322). In a final order issued in late November, 2001, the court made some modest changes without affecting the bottom line. The district court issued a stay of its order pending appeal. On September 17, 2003, the Second Circuit affirmed largely for the reasons set forth in the District Court opinion, which the appeals court held to be not unreasonable and supported by the evidence. A petition for rehearing en banc was denied on January 9, 2004. The stay of the final district court order remains in effect, by order of the Second Circuit issued February 2, pending the filing of a cert. petition in the Supreme Court.

## ARBITRATION

2. Mandel v. Household Bank (Nevada) (Cal. App. 4th, No. GO29531). On January 7, 2003, in a case in which ABA appeared as amicus curiae, court upheld the enforceability of an arbitration clause added by statement stuffer to a credit card agreement against a variety of challenges. The one provision of the contract the court did not approve was a prohibition of class action arbitrations. That, according to the court, was unconscionable. One week later, in Discover Bank v. Superior Court of Los Angeles County (Boehr, Real Party in Interest) (Cal. App. 2d, No. B161305), a different appellate division of the state court of appeals specifically and by name disagreed with the *Mandel* decision and enforced the arbitration clause as written, including its prohibition against class action arbitrations. On February 11, 2003, the Ninth Circuit, dealing with the same issue, sided with the *Mandel* court (Ting v. AT&T, 319 F. 3d 1126, pet. for cert. filed April 16, No. 02-1521; cert. denied Oct. 6, 2003). The California Supreme Court has granted review in both state cases. Proceedings in *Mandel* are stayed pending the outcome of *Boehr*; Plaintiff's opening brief in *Boehr* was filed May 9, 2003. On August 13, ABA and two co-sponsors filed amici brief in *Boehr* contending that the Federal Arbitration Act requires that arbitration clauses be enforced as written, preempting any state law or court decision to the contrary.

## CONSUMER PROTECTION

3. Household Credit Services v. Pfennig (S. Ct. No. 02-857). For 30 years, Regulation Z has instructed that "overlimit fees" on credit card accounts were "other charges" and had to be disclosed as such; they were not "finance charges" and did not figure in the calculation of an APR. On April 11, 2002, a panel of the Sixth Circuit held that overlimit fees, under the right circumstances, are charges incident to the extension of credit and, therefore, are



finance charges within the plain meaning of the Truth in Lending Act, the Federal Reserve's long-standing regulation to the contrary notwithstanding. MBNA, successor in interest to Household, filed a petition for rehearing and rehearing en banc. On April 24, 2002, ABA and four co-sponsors and the Federal Reserve filed amici briefs supporting that petition, arguing that the panel had been operating under a serious factual misunderstanding of how the credit card system actually works, without the benefit of any evidence on that subject. The petition for panel rehearing was denied and an amended decision was issued on July 2, 2002 (295 F.3d 522). The Petition for Rehearing en banc was denied in early September. Petition for Writ of Certiorari filed December 2, 2002. Supporting amici brief filed by ABA and co-sponsors on February 4. On May 30, the Solicitor General filed a brief setting forth the view of the United States that certiorari should be granted. The Court granted certiorari on the last day of the term, June 27. ABA and various co-sponsors filed amici brief on August 18 arguing that uniform treatment of disclosure for over-limit fees as "other charges" was the only practical way to convey useful and understandable information to consumers as the Truth in Lending Act intended. Oral argument held February 23.

4. Koons Buick Pontiac GMC v. Nigh (S. Ct. No. 03-377). In February, 2000, a used vehicle transaction went horribly awry, resulting in litigation by the buyer/borrower against the vehicle dealer/lender for violation of the Truth in Lending Act and numerous other claims. A jury awarded the plaintiff over \$24,000 in damages under the Truth in Lending Act. On appeal, the lender argued that there is a statutory cap on damages--twice the finance charge, but not to exceed \$1,000 (15 U.S.C. § 1640(a)(2)(A)). Nevertheless, on February 4, 2003, the Fourth Circuit affirmed, holding that since the 1995 amendments to the statute, that \$1,000 cap applied only to certain consumer lease arrangements. Prior circuit precedent had held the cap applicable to transactions of the sort at issue here as well, and there is no evidence of an actual Congressional intent that the cap would no longer apply. Notwithstanding that, Congress did what it did in 1995, and the court gave effect to the new "plain language of the statute" (4th Cir. No. 01-2201). Petition for writ of certiorari filed September 4, 2003. On October 14, ABA and two co-sponsors filed amici brief in support of the petition. The Court granted certiorari on January 20, 2004.

5. Chevy Chase FSB v. Wells (S. Ct. No. 03-918). In a credit card agreement, a bank then located in Maryland included a "choice of law" provision making the agreement governed by the laws of Maryland (specifically a provision having to do with the method of disclosing changes in terms to customers) and applicable federal law. Upon the bank's relocation to Virginia, it changed the terms of the agreement and made disclosures of those changes, though perhaps not in the form required by Maryland. Trial court dismissed a subsequent suit by consumers holding that the Maryland law was preempted by Home Owners Loan Act and OTS regulations. The Court of Appeals reversed on September 23, 2003. While the court agreed that the state law itself was preempted, it held that the parties to the contract had agreed, by means of the reference to Maryland law, to be bound by it notwithstanding federal preemption (Md. Ct. App., No. 41, September Term, 2002). Petition for Writ of Certiorari filed December 23, 2003. On January 29, ABA and Consumer Bankers Association filed amici brief supporting the Petition, contending that if the

Maryland court's reasoning is followed, virtually all "choice of law" clauses could be read to waive the defense of federal preemption.

6. McIntosh v. Irwin Union Bank & Trust Co. (1st Cir. No. 02-8022). On May 13, 2003, U.S. District Court for Massachusetts held, among other things, that borrowers seeking rescission of a loan for alleged Truth in Lending Act violations could proceed with their case as a class action (215 F.R.D. 26), and lender appealed. On September 23, Massachusetts Bankers Association, ABA and two other co-sponsors filed a motion for leave to participate in the appeal as amici curiae because of the immense practical consequences of allowing class-wide rescission. On October 9, however, the First Circuit refused to entertain an interlocutory appeal of the class certification order.

7. Wells Fargo Bank, N.A. v. Boutris (9th Cir. Nos. 03-16194, 16197, 16461). California law prohibits charging interest on residential first mortgages more than one day prior to the recording of a mortgage deed, even though the borrowed funds may have long since been disbursed. On January 27, 2003, national bank sued to enjoin investigation and enforcement of the statute by the state's Department of Corporations. The complaint alleged that only the Comptroller of the Currency may exercise visitorial powers over national banks and their separately incorporated nonbank subsidiaries, and that the prohibition in the law was preempted by the Depository Institutions Deregulation and Monetary Control Act of 1980, from which California had not "opted out." On May 9, 2003, court granted summary judgment to Wells Fargo, holding that the Comptroller has exclusive "visitorial" powers over national banks and their nonbank operating subsidiaries, and that the per diem statute was indeed preempted by DIDMCA (252 F. Supp. 2d 1065)(See also National City Bank of Indiana v. Boutris (E. D. Cal. No. S-03-0655 GEB JFM [May 7, 2003] and 2003 WL 21536818 [July 2, 2003]). Department of Corporations appealed and final briefs were filed January 16, 2004.

Two "clones" of this case are currently pending in district courts elsewhere:

Wachovia Bank, N.A. v. Burke (D. Conn. No. 3:03 CV 0738 [JCH]) was filed in April, 2003, challenging Connecticut's requirement that a state-chartered nonbank mortgage subsidiary of a national bank to be licensed under rules applicable to other mortgage lenders. Wachovia filed a motion for summary judgment in the case and that motion drew an opposing amici curiae brief on behalf of the attorneys general of 35 states that was filed August 26, 2003. ABA and other co-sponsors filed an amici brief supporting Wachovia on September 25.

Wachovia Bank, N.A., v. Watters, (D. Mich. Civil Action No. 5:03CV0105) was filed against the Commissioner of the Michigan Office of Financial and Insurance Services during the summer of 2003. A motion for summary judgment has been filed in this case as well, and supporting amici briefs were filed by Consumer Mortgage Coalition, ABA and others on January 30, 2004.

8. National Home Equity Mortgage Association v. Office of Thrift Supervision (D.D.C. Civil Action No. 1:02CV02506). OTS rules (67 Fed. Reg. 60542, September 26, 2002, effective July 1, 2003) changed the agency's prior views on AMTPA preemption. Previously, there was an apparent understanding that the AMTPA preemption clause was self-executing; now it appears that preemption occurs only upon promulgation of implementing OTS rules that specifically state that they are preemptive. On December 20, 2002, a lawsuit was filed challenging the validity of those rules. On July 14, 2003, the court granted summary judgment to the agency, holding that AMTPA itself did not clearly preempt all state laws touching on the area, that OTS had substantial authority to choose which of its regulations applicable to federal thrifts would preempt state law with respect to state-chartered lenders (and which would not) and that OTS did not abuse its discretion in making the choices it did.

On April 24, 2003, the New Jersey Appellate Division held that AMTPA does not preempt the state's Prepayment Law, Market Rate Consumer Loan Act or Consumer Fraud Act. (Glukowsky v. Equity One, Inc., N.J. App. Div. No. A-3202-01T3). Motion for reconsideration was denied June 17. The defendant sought certification from the New Jersey Supreme Court. ABA and co-sponsors filed a brief supporting certification on August 1, 2003. Court granted the certification and oral argument was held February 3, 2004.

9. Bank One v. Wilens (C.D. Cal. No. SACV 03-01258 JVS (ANx)). California law requires that certain disclosures be made in connection with a bank's offering of "convenience checks" to customers. Wilens filed suit against the bank in state court to enforce this obligation even though she had and alleged no personal harm arising from the charged noncompliance. California law permits such a suit as a "private attorney general" acting on behalf of the general public. Bank One, in turn, filed suit in federal court to enjoin any such state court litigation on the grounds that it would constitute in essence an enforcement action, and that is a matter left by federal law exclusively to the Comptroller of the Currency under the "visitorial powers" provision of the National Bank Act. In October, 2003, the court issued a tentative order denying the defendant's motion to dismiss the bank's complaint as barred by the Anti-Injunction Act and granting the bank's motion for summary judgment. (See also, Bank One v. Wilens, 2003 WL 21703629 (C.D. Cal., July 8, 2003))

\* 10. Riley v. Fleet National Bank (D. Mass. No. 03-10123 NGJ). On January 23, 2003, a class action suit was filed by Social Security recipients claiming that it was a violation of the anti-alienation provisions of the Social Security Act for a bank, exercising its general contractual right of setoff, to take funds from the bank accounts of the plaintiffs in satisfaction of overdue loan payments when the source of the funds in the accounts were only monthly Social Security benefits.

\* In a similar case, Miller v. Bank of America, (Cal. Super., San Francisco County. No. 301917) a state judge, specifically disregarding the controlling Ninth Circuit precedent, Lopez v. WaMu, 302 F. 3d 900, instructed a jury that Social Security benefits could not be taken by setoff to cover overdrafts and associated fees. On February 25, 2004, the jury found the bank in violation of the state's unfair business practices act for doing so and awarded \$75 million in damages plus

\$1,000 for each of an estimated 1.1 million class members. On April 1, the plaintiff is scheduled to file a motion for an injunction against any continuation of Bank of America's practices in this respect. The Bank will file its reply April 30, and a hearing is set for May 12.

11. Smith v. Chrysler Financial Co., L.L.C. (D. N.J. Civil Action No. 00-6003). Auto dealers originate and technically make loans to customers, then immediately assign such loans to captive finance company. Finance company sets a "buy rate," the lowest interest rate at which it will take a dealer-originated loan. The dealer is free to originate loans at a higher rate than that, with the dealer and finance company then splitting the difference. African-American borrowers alleged disparate treatment by a dealer in violation of the Equal Credit Opportunity Act in that African-Americans ended up paying disproportionately greater discretionary finance charges and higher rates than otherwise identically situated white borrowers. Finance company, though it did not originate or make the loans, was also named as a defendant. ABA and three co-sponsors filed an amici brief on April 17, 2001, arguing, among other things, that assignees of dealer paper are specifically excluded from the definition of "creditor" in the Equal Credit Opportunity Act in the absence of knowledge of discrimination. See also Jones v. Ford Motor Credit Co., 2002 WL 88431 (S.D.N.Y., January 22, 2002) (allegation that Ford "authorized subjective markups" having a disparate impact was sufficient to state a claim under ECOA).

12. Schwartz v. Visa International (Alameda Co. [Cal.] Super. Ct. No. 822404-4). On April 7, 2003, a state court ordered Visa and Mastercard to amend their respective rules and regulations to assure "full and effective disclosure" of currency conversion fees charged to customers who incur debts denominated in something other than U.S. dollars, and to make restitution to customers charged such a fee since February, 1996. Similar cases have been filed in state courts in eight other states. Visa and Mastercard currency conversion fees are also challenged on antitrust grounds in a case before the Southern District of New York where the court, in July, 2003, denied a motion to dismiss the complaint. American Express is defendant in a series of similar cases in the Southern District of Florida.

13. Department of Legal Affairs v. Lehman Commercial Paper (Broward Co. [FL] Cir. Ct. No. 0310116). In June, 2003, state Attorney General filed suit alleging that First Alliance Mortgage Co. engaged in predatory lending practices through unfair and deceptive trade practices and through fraud in violation of state law. According to the complaint, First Alliance could not have done so but for financing provided by Lehman Commercial which actually knew or should have known of First Alliance's practices. The complaint seeks an injunction against Lehman Commercial's engaging in financing activities for *any* mortgage or consumer lender in Florida, and for actual damages to consumers, punitive damages, civil penalties, costs and attorney's fees.

14. People of the State of New York v. First Horizon Home Loan Corp. (S.Ct. of N.Y. [Albany County] Index No. -----). On or about January 20, 2004, Attorney General of New York released a Complaint against an operating subsidiary of a national bank for alleged violations of the state's General Business Law. The Complaint alleges that mortgage borrowers carried out the terms of their 25-year mortgage, but that the defendant (who had acquired the loan from the original

lender) refused to release the lien and required additional payments. It seems the original lender had miscalculated the monthly P&I payment by about \$16 in favor of the borrower, and the acquiring lender wished to recover the 25 years accumulated shortfall. The lenders efforts are said to violate the GBL, which makes it unlawful for a creditor to assert a claim that it knows does not exist, and makes it unlawful to commit deceptive acts and practices.

A week before the complaint was released, the Comptroller of the Currency published a final rule in the Federal Register in which he claimed that the National Bank Act granted him exclusive visitatorial powers over national banks and their nonbank operating subsidiaries, so as to preclude state authorities from enforcing state laws against them (69 Fed. Reg. 1895 [January 13, 2004]). The state Attorney General's action here is admittedly a test case designed to challenge the validity of the Comptroller's rule in a concrete setting (and in a state court rather than a federal court). The fact that the lender and the borrower have now long since resolved the dispute between them extrajudicially seems to be of no consequence.

15. Mayor of the City of New York v. Council of the City of New York (Supreme Court, County of New York, Index No. 400583/03). City Council enacted Local Law 36 prohibiting city from doing business with "predatory lenders" over the Mayor's veto and the Mayor sued, claiming that the action was a legislative infringement upon his executive powers under the city charter. American Financial Services Association intervened alleging that the ordinance was preempted by federal and state law. On January 26, 2004, court held that the ordinance was preempted. While the court acknowledged that the city had every right to select the parties with which it chose to contract, that is not what the Council did here. Instead, it promulgated a detailed code of conduct for lenders. That is the prerogative of the federal and state governments, not the city's.

#### CREDIT UNIONS

16. American Bankers Association v. National Credit Union Administration (D. Utah, No. 2:03cv00621 JTG). On July 15, 2003, ABA, Utah Bankers Association and four member banks sued the regulator of federal credit unions for its approval of a six-county area of northern Utah, containing 1.4 million people and two distinct Standard Metropolitan Statistical Areas, as a "local well defined community" and authorizing three federal credit unions to serve that "community." The bankers contend that it is an abuse of discretion, in light of the actual facts, to find that the area in question is a single community in which the residents interact and share common interests. The three credit unions in question and three credit union trade groups moved to intervene as parties in the case and the defendant agency has filed an answer to the complaint. On February 11, court refused to allow plaintiffs to conduct even limited discovery, concluding that review was limited to the administrative record—which had not yet been filed. ABA brief on the merits of the case is due May 3.

## PRIVACY

17. Bank of America v. City of Daly City (9th Cir. Nos. 03-16682, 16689). The City of Daly City, Contra Costa County and San Mateo County, near San Francisco, enacted ordinances that constrained all financial institutions with business locations in the City or in the unincorporated areas of the counties from sharing information about their customers among their affiliates. On September 10, 2002, two national banks and their affiliates filed suit contending that the ordinances were preempted by federal laws, including the Fair Credit Reporting Act, the National Bank Act and the Gramm-Leach-Bliley Act, and that the ordinances were unconstitutional insofar as they purported to have extraterritorial application. After discovery, the plaintiffs filed a renewed motion for summary judgment; Comptroller of the Currency, ABA, California and Oregon Bankers Associations and other co-sponsors filed supporting amici brief. On July 29, 2003, court granted summary judgment in part to the banks, concluding that the ordinances were preempted by the federal Fair Credit Reporting Act to the extent that the local law impacted the ability of the banks to share information among affiliates. Local law was not preempted to the extent that it affected information sharing with a third party. The court did not officially address the banks' alternative claims about preemption of local law by the National Bank Act or by Gramm-Leach-Bliley (N.D. Cal. No. C-02-4343-CW). The banks filed a notice of appeal on September 9, 2003, raising the Gramm-Leach-Bliley Act issue anew, and submitted their opening brief on December 23, 2003.

18. Federal Trade Commission v. Mainstream Marketing Services Inc. (10th Cir. No. 03-1429). Association representing telemarketers filed suit on January 29, 2003, challenging FTC's creation of a national "do not call" list, contending that it violates First and Fifth Amendment rights, is in excess of statutory authority and is arbitrary and capricious. A companion case was filed the same day by the Direct Marketing Association in federal district court in Oklahoma City (U.S. Security v. FTC, W.D. Okla. No. 03-122-W). On September 23, 2003, the Oklahoma federal court held that the FTC lacked the statutory authority to adopt, implement and enforce the do not call rule. That outcome was changed by legislation that was introduced, passed by both houses of Congress and signed by the President in six days. On September 25, however, the Colorado federal court held the do not call rule unconstitutional as a violation of the First Amendment in that the rule exempted charities, politicians and some others while binding commercial callers. According to the court, this is a content-based restriction on speech. Since charities and politicians are every bit as irritating and intrusive as commercial callers, the rule cannot be justified as serving consumers' "privacy interests." (D. Colo. No. 03-N-184). Importantly, both courts upheld other aspects of the do not call rule such as the prohibition against "predictive dialing" that results in more than 3% "abandoned calls."

The Federal Communications Commission adopted a rule complementary to the FTC's so as to cover certain industries (such as our own) not subject to FTC jurisdiction. On July 28, 2003, a Petition for Review of that rule was filed. American Teleservices Association v. FCC (10th Cir. No. 03-9571). On September 26, the court denied a request for a stay of that rule, holding that the telemarketers had not demonstrated a sufficient likelihood of success on the merits to warrant a stay. On September 29, the circuit Justice (Breyer) declined, on behalf of the Supreme Court, to

disturb that holding. Thus the FCC rule went into effect as scheduled on October 1, 2003, though the FTC rule on which it was premised in the first place did not. The Colorado federal court said, also on September 29, that the FTC would be in contempt if it shared its do not call list with the FCC. The FTC appealed that to the Tenth Circuit on September 30. On October 7, the Tenth Circuit issued a stay of the district court's permanent injunction, holding that the balance of harms tipped ever so slightly in favor of the FTC and that the FTC had shown a sufficient likelihood of success on the merits to warrant the stay (345 F. 3d 850). The FTC announced that it would begin enforcement immediately. On February 17, 2004, the court issued an opinion in four consolidated cases upholding the constitutionality and statutory authority for the list as a narrowly tailored method of pursuing the important governmental interests of protecting its citizens' privacy in their own homes and at their own instigation. The fact that the list did not bar charitable or political calls does not change the result. "Underinclusiveness" is a First Amendment problem only if it results in an effort that is so insignificant as to be hardly worth the effort--clearly not the case here.

19. New York State Bar Association v. Federal Trade Commission (D.D.C. No. 1:02cv00810). Gramm-Leach-Bliley Act requires "financial institutions" to disclose privacy policies to their clients and establishes civil sanctions of up to \$10,000 per violation for failure to do so. By FTC's definition, "financial institution" is one that provides services to clients that are "financial activities." Arguably, that would include attorneys engaged in tax planning, estate planning, real estate closings and bankruptcy, although there is little doubt that Congress had no such thing in mind when it enacted the law. Bar association sought an exemption from FTC's privacy rules for such attorneys or at least an interpretation of the law or regulations to the effect that it did not apply to attorneys. FTC refused to provide any guidance on the subject one way or the other. On April 29, 2002, the association filed suit claiming that the agency's unwillingness to grant an exemption was arbitrary and capricious. The American Bar Association filed essentially the same lawsuit in the same court in September, 2002. The two cases were consolidated. The court denied a motion to dismiss the complaints on August 11, 2003, finding that "it does not appear that Congress intended for the privacy provisions of the GLBA to apply to attorneys." On December 27, 2002, a comparable case was filed in North Carolina (North Carolina Bar Association v. Federal Trade Commission [E.D. N.C. No. 5:02cv941]).

20. National Coalition of Prayer, Inc. v. Carter (S.D. Ind. No. IP02-0536C-B/S). Various charitable organizations are challenging the constitutionality of the Indiana Telephone Privacy Act of 2001, which creates a "do not call" list, on First Amendment grounds in a noncommercial speech context. While the statute, by its own terms, exempts charitable organizations, it does so only to the extent that the organizations use only actual employees or volunteers to make the phone calls, not third party solicitors. Plaintiffs filed motion for summary judgment September 10, 2002.

21. American Council of Life Insurers v. Vermont Department of Banking (Washington County [VT] Superior Ct. No. 56-1-02 Wncv). In November, 2001, state regulator of banking, insurance, securities and healthcare administration promulgated regulations, effective February 15, 2002, that purports to govern the disclosure of nonpublic personal financial and health information

about individuals by Vermont licensees subject to the Commissioner's jurisdiction to non affiliated third parties. On January 30, 2002, five insurance trade associations filed suit contending that there is no state law that grants power to the Commissioner to issue regulations governing this subject matter, at least as to the insurance business, and that therefore the regulations are in excess of her statutory authority. On February 12, 2004, trial court denied the trade associations' motion for summary judgment and granted summary judgment to the Commissioner. The generality and expansive nature of the rulemaking authority granted to the Commissioner by statute was sufficient to justify this particular rule even though no specific mention of authority to adopt rules in this area is made in the statute.

\* 22. Nationwide Mutual Insurance Co. v. Martino (W.Va. S. Ct. of App. No. 31270). Plaintiff sought information about the defendant from the defendant's insurance company in connection with the filing of a personal injury lawsuit. The insurance company resisted the request for information, contending that the privacy provisions of the Gramm-Leach-Bliley Act and comparable state insurance regulations prohibited the company's dissemination of nonpublic personal information about its customers. The plaintiff then sued the insurance company for bad faith. The Circuit Court of Harrison County certified the legal issues raised by the insurance company's position to the state Supreme Court of Appeals for resolution. On April 10, 2003, the high court accepted that certification. The insurance company filed its opening brief May 12; West Virginia Bankers Association and ABA filed a supporting amici curiae brief the same day. On March 15, 2004, the court found that GLBA and state insurance regulations both contained an exception for judicial proceedings and that exception was broad enough to cover requests for information of the sort at issue here, even though, at the relevant time, no suit had been filed and the insurance company was not and was not expected to be a named party to any such suit. The court did conclude that it was not a blanket exception, and that trial judges should be generous in granting protective orders to assure that privacy interests were safeguarded and only absolutely essential nonpublic personal information be disclosed even in judicial proceedings.

#### PRODUCTS & SERVICES

\* 23. Massachusetts Bankers Association v. Bowler (D. Mass. No. 03 CV 11522 JLT). In February, 2003, the First Circuit dismissed a Petition for Review filed by the Massachusetts Insurance Commissioner challenging a determination by the Comptroller of the Currency that various provisions of the Commonwealth's insurance statutes were preempted with respect to national banks by the Gramm-Leach-Bliley Act. The court held that there was no justiciable controversy presented by that Petition since the Comptroller's determination did not have and was not intended to have the force and effect of law. That decision, of course, left unresolved the question of whether the provisions of the statute at issue applied to the banks or not. On August 13, 2003, Massachusetts Bankers Association and eight individual institutions filed suit against the insurance commissioner for a declaratory judgment to the effect that those same provisions of the statute were indeed preempted by the federal law. ABA and four cosponsors filed an amici brief on March 19 supporting the MBA's motion for summary judgment. Oral argument is set for April 27.



24. Fidelity National Information Solutions v. Sinclair (E.D. Pa. No. 02-6928). Pennsylvania law, 63 P.S. §§ 457.1, et seq., requires appraisals in non-federally related transactions, and requires that such appraisals be performed by Pennsylvania board-certified appraisers. Fidelity National provides, and sells to lenders, a comparatively inexpensive, largely automated "evaluation" of the value of properties that are to serve as security for mortgages. On August 26, Fidelity filed suit to enjoin enforcement of the Pennsylvania law, alleging that federal law and regulation specifically allows the use of something less than a full-blown appraisal under certain circumstances (e.g. mortgage loans of less than \$250,000), and that that federal law preempts contrary state law. In September, 2002, the Pennsylvania Bankers Association, on behalf of its members who would be deprived of a valuable product by virtue of the Board's enforcement actions, joined the case as a named plaintiff. On February 19, 2003, ABA joined suit as a plaintiff on behalf of its non-Pennsylvania members to allege that Pennsylvania law constituted an undue burden on interstate commerce as well. The defendants filed a motion for judgment on the pleadings on April 16, 2003. ABA and the other plaintiffs filed a responsive brief on July 29.

25. American Land Title Association v. Radian Group (Cal. Super., Orange County, Case No. \_\_\_\_\_). Under California state law, it is illegal to sell title insurance in the state without being licensed, and any insurer which transacts any class of insurance other than title insurance anywhere in the United States is ineligible for a title insurance license. Radian Group is a private mortgage insurer that sells, among other things, a "lien protection program" to residential mortgage lenders. The lien protection program is said to accomplish essentially the same goals as traditional title insurance, but is sufficiently different in its structure so as to fall outside the definition of "title insurance." Being unimpressed by the fine points, the trade association for title insurers filed suit in late November, 2001, contending that Radian was engaged in the unlicensed and illegal sale of title insurance in California. On June 20, 2002, the California Department of Insurance, in a separate proceeding, concluded that the lien protection program was, indeed, title insurance, and issued a cease and desist order to Radian. Several other state insurance commissioners have reached the same conclusion. On April 15, 2003, however, the California Insurance Commissioner rejected his Department's conclusions and, while leaving the ban temporarily in place, called for the taking of additional evidence and legal argument. On July 22, the Commissioner released his decision after the consideration of the additional materials, and elected to affirm the original Department decision. Radian is expected to appeal.

#### TRUST

26. Tittle v. Enron (S.D. Tex. No. H-01-3913). Among the myriad of issues to be litigated in this massive consolidated *Enron* case is the question of any responsibility for the fiasco that directed trustees might have. These are the financial institutions that held the Enron employees' savings plans while the value of those plans, largely invested in Enron stock, plummeted, and during a "lockout period," during which employees were not permitted any transactions within their respective plans. The trustees have moved to dismiss complaints as to them on the grounds that their status, duties, responsibilities and liabilities as directed trustees were specifically recognized and governed by ERISA, and that they lacked the legal and contractual capacity to conduct

themselves in any fashion other than the way they did in this case. On August 30, 2002, the Secretary of Labor filed an amicus brief opposing the motions to dismiss, seeking to impose upon directed trustees a higher duty than has previously been recognized for them. In October, ABA filed amicus brief addressing only the Secretary's arguments, pointing out that they were unsupported by statutory language and contradicted by legislative history. On September 30, 2003, the court refused to dismiss out the trustees, adopting the Secretary of Labor's view of the case.

#### MISCELLANEOUS

27. Federal Deposit Insurance Corporation v. Ernst & Young. (7th Cir. No. 03- \_\_\_\_). When Superior Bank, FSB, an insured institution, failed, FDIC was appointed receiver. It proceeded to file a complaint *in its corporate capacity* against the bank's auditor for gross negligence, fraud and accounting malpractice for having blessed a variety of accounting methods that had enabled Superior to exaggerate its financial condition. On April 15, the court dismissed the suit holding that FDIC lacked standing to sue in its corporate capacity. Had the agency filed the suit in its capacity as receiver, it would have been bound by a mandatory arbitration clause in the contract between E&Y and Superior Bank (in whose shoes FDIC as receiver would stand) (N.D. Ill. No. 02 C 7914). Notice of appeal filed July 28, 2003.

28. Community Bank & Trust v. United States (Ct. Fed. Cl. No. 01-571 C). On October 3, 2001, Texas state-chartered bank filed suit on its own behalf and as representative of all depository institutions required to maintain reserves with Federal Reserve Banks since 1980. It seeks to compel the government to pay interest to the depository institutions on those reserves. Failure to do so is said to constitute wrongful conversion of the plaintiffs' property, unjust enrichment to the government, deprivation of property without due process and unlawful taking of property for public use without just compensation in violation of the Fifth Amendment.

\* 29. Kitson v. Bank of Edwardsville (Ill. App. 5th Dist. No. 5-04-0199). In a series of commercial promissory notes, bank specified a particular interest rate and disclosed that the interest would be calculated on a 365/360 basis. Borrower filed suit claiming that the 365/360 method resulted in an actual interest rate that was .138% above the stated rate and the discrepancy was a violation of the Illinois Consumer Fraud and Deceptive Business Practices Act. Trial court certified the case as a class action and denied the bank's motion for judgment on the pleadings. On application by the bank, the court certified questions to the Appellate Court for an interlocutory appeal. On March 25, ABA and Illinois Bankers Association filed a brief urging the Appellate Court to exercise its discretion in favor of granting the interlocutory appeal based upon the importance of the case to the industry at large. Most commercial loans calculate interest on the 365/360 basis and hundreds of thousands of such loans disclose that method of calculation in language identical to that used in the notes at issue here.

30. Pioneer Commercial Funding v. American Financial Mortgage Corp. (S. Ct. Pa. No. 279 EAL 2002). American Financial was indebted to CoreStates Bank by reason of a series of overdrafts. When a wire transfer of funds arrived in the American Financial deposit account at

CoreStates, the bank applied it to offset the debt. Pioneer, which had a series of dealings with American Financial, claimed that the wire-transferred funds actually belonged to it, instead, and that the funds had been wired to the American Financial account in error. They should have been wired to Pioneer's account in another bank. CoreStates declined to reverse the offset and Pioneer sued. A jury awarded actual, consequential and punitive damages against the bank and the bank appealed. The Pennsylvania Superior Court affirmed on most issues, but vacated the punitive damages award and remanded for a new trial on that issue alone (797 A. 2d 269). The bank sought allowance from the Pennsylvania Supreme Court to appeal and that was granted on December 2, 2003. On January 26, 2004, ABA and Pennsylvania Bankers Association filed amici brief urging reversal based upon the bank's perfectly correct adherence throughout the transaction to Article 4A of the UCC. Oral argument scheduled for April 13.

#### CALENDAR

April 13	Oral argument in <u>Pioneer v. American Financial</u> .
April 19	Opening Briefs due in <u>Koons v. Nigh</u> .
April 27	Oral argument in <u>Mass. Bankers v. Bowler</u> .
April 30	Briefs due in <u>Miller v. Bank of America</u> .
May 3	Brief due in <u>ABA v. NCUA</u> .
May 12	Oral argument in <u>Miller v. Bank of America</u> .



**CIVIL LITIGATION RESULTING FROM  
THE ERPENBECK FRAUD:  
*Mitchell v. Peoples Bank of Northern Kentucky*  
WHAT WERE THE ISSUES AND ARGUMENTS?**

***John K. Bush  
Greenebaum Doll & McDonald PLLC  
Louisville, Kentucky***

Copyright 2004. John K. Bush. All Rights Reserved.

**SECTION C**



**CIVIL LITIGATION RESULTING FROM  
THE ERPENBECK FRAUD:  
*Mitchell v. Peoples Bank of Northern Kentucky*  
WHAT WERE THE ISSUES AND ARGUMENTS?**

<b>ERPENBECK'S FRAUD .....</b>	<b>C-1</b>
<b>THE CLAIMS IN THE <i>MITCHELL</i> LITIGATION SUMMARIZED .....</b>	<b>C-2</b>
<b>THE PLAINTIFFS' SUMMARY JUDGMENT ARGUMENTS .....</b>	<b>C-4</b>
<b>THE PEOPLE BANK DEFENDANTS' SUMMARY JUDGMENT ARGUMENTS ...</b>	<b>C-5</b>
<b>THE PLAINTIFFS' OTHER CLAIMS AND THE PEOPLES BANK DEFENDANTS' RESPONSES .....</b>	<b>C-11</b>
<b>FRAUD .....</b>	<b>C-11</b>
<b>NEGLIGENCE .....</b>	<b>C-12</b>
<b>POSSIBLE SCENARIOS .....</b>	<b>C-15</b>
<b>CONSTRUCTION LENDERS V. PEOPLES BANK V. EVERYONE ELSE .</b>	<b>C-15</b>
<b>CONSTRUCTION LENDER V. HOMEOWNER AND HOMEOWNER'S     LENDER V. EVERYONE ELSE .....</b>	<b>C-18</b>
<b>HOW THE CASE WAS RESOLVED .....</b>	<b>C-22</b>





**Civil Litigation Resulting From the Erpenbeck Fraud:  
*Mitchell v. Peoples Bank of Northern Kentucky*  
What Were the Issues and Arguments?**

by

**John K. Bush  
Greenebaum Doll & McDonald PLLC<sup>1</sup>  
March 26, 2004**

***Erpenbeck's Fraud***

The Commissioner of the Kentucky Department of Financial Institutions called it perhaps the biggest bank fraud ever committed in Kentucky. What may have been the biggest was also among the most audacious: At hundreds of new home sale closings, the seller-builder's representative received from the closing agent the check intended to repay the seller-builder's construction loan for the property. Then, instead of delivering the loan payoff check to the construction lender as promised (and thereby obtaining a release of the construction lien), the seller-builder deposited the check into the seller-builder's own bank account. Millions of dollars in construction loan payoff checks were accepted for deposit into the seller-builder's account, despite the fact that in most instances the payee on the check was the construction lender, not the seller-builder.

From 2000 through the beginning of 2002, hundreds of Northern Kentucky homeowners were victims of this fraud. The seller-builders were companies owned or controlled in whole or in part by A. William Erpenbeck, Jr., then one of the largest residential builders in the greater Cincinnati metropolitan area. In the spring of 2002, the Erpenbeck empire collapsed, and the

---

<sup>1</sup>Mr. Bush is a member of Greenebaum Doll & McDonald PLLC and practices in its Louisville office. He is one of the attorneys who represented Peoples Bank of Northern Kentucky and its directors in the *Mitchell* litigation. Mr. Bush gratefully acknowledges the assistance of Andrew M. Fleischman, Janet P. Jakubowicz, Christie A. Moore and W. Plumer Wiseman in the preparation and review of this article, much of which is taken from briefs filed in the case.

defrauded homeowners learned that they each had an additional lien on his or her residence – a first mortgage held by one of the Erpenbeck companies' lenders. Soon thereafter, the bank where the Erpenbeck companies had deposited the majority of the construction lender payoff checks – Peoples Bank of Northern Kentucky ("Peoples Bank") – found itself faced with a multi-million dollar class action lawsuit brought by the homeowners.<sup>2</sup>

### ***The Claims in the Mitchell Litigation Summarized***

*Mitchell v. Peoples Bank of Northern Kentucky*<sup>3</sup> was filed on May 9, 2002, in the Circuit Court of Boone County, Kentucky, on behalf of a class of some 210 homeowners who owned properties for which lender payoff checks had been diverted by Erpenbeck.<sup>4</sup> Although *Mitchell* was eventually settled without trial or ruling by the Court on any substantive questions of fault, the case presented fascinating legal issues regarding whether and, if so, how to allocate liability amongst the various parties.

---

<sup>2</sup>Peoples Bank and its directors also were named as defendants in other civil litigation, including class actions brought by Erpenbeck's subcontractors, see *Morris Heating & Cooling, Inc. v. Peoples Bank of Northern Kentucky*, Case No. 2002-165-WOB (E.D. Ky.), certain Peoples Bank shareholders, see *Eschenbach v. Peoples Bancorporation of Northern Kentucky*, Case No. 02-CI-1245 (Campbell County Circuit Court), and the so-called "cash closing" purchasers (i.e., those who purchased homes from Erpenbeck by writing a check for the full amount of purchase payable to an Erpenbeck entity, as opposed to one of Erpenbeck's lenders), see *Schulte v. Peoples Bank of Northern Kentucky*, Case No. 2002-258 (E.D. Ky.). The *Morris Heating & Cooling* and *Eschenbach* cases remain pending and a settlement of *Schulte* is pending for final court approval as of the date of this article. The scope of this article is limited to the *Mitchell* case and does not address the issues presented in any other case involving Peoples Bank and its directors.

<sup>3</sup>Case No. 02-CI-00691 (Boone County Circuit Court).

<sup>4</sup>Prior to the *Mitchell* suit, Peoples Bank had filed its own action against the Erpenbeck companies, closing agents, title companies and construction lenders. See *Peoples Bank of Northern Ky. v. Erpenbeck*, Case No. 02-CI-1210 (Campbell County Circuit Court). Peoples Bank dismissed this complaint without prejudice soon after the *Mitchell* complaint was filed, then refiled it in Boone County Circuit Court, where *Mitchell* was pending. See *Peoples Bank of Northern Kentucky v. Erpenbeck*, Case No. 02-CI-719 (Boone County Circuit Court).

Of course, Erpenbeck and his companies were culpable, but beyond that, who among the other parties to the transactions (each of whom also claimed to be innocent victims of Erpenbeck's fraud) was liable for the homeowners' losses? The plaintiffs chose to sue only Peoples Bank and its directors, and the complaint sought damages on claims of fraud, negligence and unlawful conversion. Yet, as explained below, despite the homeowners' undoubtedly aggrieved status, there were significant legal obstacles that stood in the way of their success on the claims they chose to bring against the People Bank defendants.

For their part, the Peoples Bank defendants denied any liability on the claims brought by the homeowners. Also, the Peoples Bank defendants brought their own claims against more than sixty (60) third parties, including Erpenbeck and his various companies, as well as the myriad of closing agents, title insurance companies and construction lenders involved in the closings at issue. The Peoples Bank defendants sought contribution, indemnity and a declaratory judgment against all third parties, in addition to damages for fraud and conversion against the Erpenbeck entities and negligence against the closing agents. The Peoples Bank defendants' defenses to the complaint and their third-party claims, of course, had their own set of formidable challenges to overcome -- not the least of which was the one stubborn fact that the plaintiffs and non-Erpenbeck third-party defendants had in their favor: Peoples Bank had accepted for deposit into Erpenbeck's account tens of millions of dollars in checks that on their face were clearly *not* made payable to Erpenbeck.

### ***The Plaintiffs' Summary Judgment Arguments***

The plaintiffs argued that, given Peoples Bank's obvious error in accepting for deposit the checks that were not payable to the account holder, they should be entitled to recovery as a matter of law against Peoples Bank and its directors. Without taking any discovery, the plaintiffs moved for summary judgment on their conversion claim. In support of their motion, the plaintiffs pointed to the portion of section 3-420(1) of the Uniform Commercial Code ("UCC"), codified at Kentucky Revised Statute ("KRS") 355.3-420(1), which provides:

The law applicable to conversion of personal property applies to instruments. An instrument is also converted if it is taken by transfer, other than a negotiation, from a person not entitled to enforce the instrument or a bank makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment.

According to the plaintiffs, the Peoples Bank defendants had effectively admitted liability for conversion by acknowledging in their pleadings that "the checks were not proper for deposit to the Erpenbeck Company's account." In addition to reliance on this "admission", the plaintiffs argued that the case law was "clear that a conversion occurs if a bank, such as Peoples [Bank], deposits a check with a forged endorsement." The plaintiffs further contended that the Peoples Bank defendants had no defense to the conversion claim because, as a matter of law, Peoples Bank had not acted in a commercially reasonable fashion by accepting for deposit the diverted checks.

### ***The Peoples Bank Defendants' Summary Judgment Arguments***

The Peoples Bank defendants not only opposed the plaintiffs' summary judgment motion, but in fact argued that they were entitled to summary judgment themselves on the conversion claim. The crux of their argument was that the plaintiff-homeowners did not have standing to bring a conversion claim.

According to the Peoples Bank defendants, the plaintiffs neither possessed nor owned the property that was allegedly converted (*i.e.*, the payoff checks) at the time of the alleged conversion. The plaintiffs therefore could not establish the first element of a common law conversion claim. This element is that the plaintiffs were, in fact, at the time of the alleged conversion, in possession or the owner of the property that was allegedly converted.<sup>5</sup>

The plaintiff-homeowners could not establish that they were in possession of the payoff checks at the time of the "conversion", the Peoples Bank defendants contended, because the payoff checks were in the possession of the Erpenbeck companies when they were deposited at Peoples Bank. Nor were the plaintiffs the owners of the checks at the time of their deposit, the Peoples Bank defendants argued. They contended that the plaintiff homeowner no longer had title to funds brought to the closing once that money went into the closing agent's escrow and title to the real property passed to the purchaser. In support, the Peoples Bank defendants quoted one court's explanation that "[t]he buyers cannot logically be the owners of both the purchased [real] property and the portion of the money in [the closing agent's] escrow" and that "[i]t simply

---

<sup>5</sup>See, e.g., *Greater Lakes Higher Educ. v. Austin Bank*, 837 F. Supp. 892, 897 (N.D. Ill. 1993) ("A party pleading an action in conversion [of a check] . . . must alleged that it had title to or possession of the check."); Haynes, *Kentucky Jurisprudence, Torts* § 6-3 (1987) (plaintiff must "establish an interest in the thing converted, *i.e.*, that he was in possession of the chattel or was entitled to possession of the chattel at the time the conversion occurred").

does not make sense to say the buyers had title to the escrowed funds while recognizing that the buyers also had title to the real property.”<sup>6</sup>

The Peoples Bank defendants supported their argument with reference to a portion of KRS 355.3-420(1) not quoted by the plaintiffs: “An action for conversion of an instrument may not be brought by: (a) The issuer or acceptor of the instrument; or (b) *A payee or indorsee who did not receive delivery* of the instrument either directly or through delivery to an agent or a co-payee.” (emphasis added). According to the Peoples Bank defendants, this provision made clear by negative inference that only a *payee* or *indorsee* who *did* receive delivery of the instrument prior to its alleged conversion has the right to sue for conversion.

The purpose of KRS 355.3-420(1), the Peoples Bank defendants argued, is to limit claims of conversion against the depository bank to the “true owner” of a check – *i.e.*, the payee or indorsee who received the check before it was converted.<sup>7</sup> Indeed, the Peoples Bank defendants noted, the statute explicitly provides that even the party who wrote the check – the “issuer . . . of the instrument”, also known as the drawer (here, the closing agent) – does not have the right to sue for conversion.<sup>8</sup> Thus, if the drawer could not bring a conversion claim, then it stood to reason, according to the Peoples Bank defendants, that the plaintiff purchasers – whose names

---

<sup>6</sup>*Stuart v. Clarke*, 619 A.2d 1199, 1200-01 (D.C. Ct. App. 1993).

<sup>7</sup>*Ostrom-Martin, Inc., v. First National Bank of Chillicothe*, 202 B.R. 267 (C.D. Ill. 1996). For example, in *Tennessee Pipe Fabricators, Inc. v. Lively*, 985 F.2d 561, 1993 WL 5915 (6<sup>th</sup> Cir. 1993) (unpublished opinion), the United States Court of Appeals for the Sixth Circuit held that the president and twenty-five percent owner of a co-payee on checks that were deposited without all co-payees’ endorsements did not have the right to sue the depository bank for conversion of the checks. The Sixth Circuit reasoned that the president “was not a payee on any of the checks, and he had no right to, or title in, them” and therefore “he had no standing to bring an action for their wrongful deposit and the attendant conversion of funds.” *Id.*, 1993 WL 5915, at \*\*2.

<sup>8</sup>See KRS 355.3-420(a)(1).

appeared nowhere on the checks or in the indorsements and who were effectively the issuers of the checks through their closing agent in any event – clearly could not do so either.<sup>9</sup>

The Peoples Bank defendants maintained that the plaintiffs' cited authority was inapposite because those cases involved conversion claims brought by a payee or a drawer under a UCC provision that had been superceded by UCC § 3-420 and that, unlike UCC § 3-420, had been interpreted by some courts to allow a drawer to sue for conversion.<sup>10</sup> The plaintiff purchasers in *Mitchell* were neither payees nor drawers on the payoff checks in question. Thus, according to the Peoples Bank defendants, the cases cited by the plaintiffs provided no support for the plaintiffs' recovery.

---

<sup>9</sup>According to the Peoples Bank defendants' argument, the fact that the payoff checks were issued from closing agents' escrow accounts into which the plaintiff purchasers and their lenders had deposited funds did not alter the fact that the plaintiffs had no claim for alleged conversion of those checks. As an example, the Peoples Bank defendants cited *Lewis v. Telephone Employees Credit Union*, 87 F.3d 1537 (9<sup>th</sup> Cir. 1996), in which the court held that purchasers of cashier's checks did not have a claim for conversion of those checks. In *Lewis*, the United States Court of Appeals for the Ninth Circuit reasoned that the purchaser of a cashier's check "is not a party to the cashier's check itself unless named as payee or unless the purchaser adds his own signature or indorsement to the instrument." *Id.* at 1552 (citation and quotation marks omitted). Thus, the appellate court concluded that even though the purchasers had purchased the cashier's checks in question, they had no property right in those checks because they were not a payee or an indorsee. The Ninth Circuit cited numerous courts from other jurisdictions holding "that remitters [i.e., purchasers] of cashier's checks do not have standing to bring a conversion claim." *Id.*; see also, e.g., *C.A.L., Inc. v. Worth*, 813 S.W.2d 12, 15 (Mo. Ct. App. 1991) ("[T]he remitter, who has purchased a cashier's check, is not the owner of the check and is not the proper party to sue for conversion."). Similarly, the Peoples Bank defendants argued, even though the plaintiff purchasers and their lenders could be deemed to have "purchased" the payoff checks (like the remitters purchased the cashier's checks) by depositing funds into escrow, the plaintiffs (like the remitters) had no conversion claim based on the checks because they were neither payees nor indorsees on the checks.

<sup>10</sup>See *First Nat'l Bank of Louisville v. Progressive Cas. Ins.*, Ky., 517 S.W.2d 226 (1975) (the plaintiff was the named payee; thief was the converter); *Chilson v. Capital Bank*, 701 P.2d 903 (Kan. 1985) (the plaintiff was the maker of a note); *Humberto Decorators, Inc. v. Plaza Nat'l Bank*, 734 A.2d 618 (N. J. 1981) (the plaintiff was the named payee); *U.S. v. Citizens Union Nat'l Bank*, 40 F. Supp. 609 (W.D. Ky 1941); *Owensboro Nat'l Bank v. Crisp*, 608 S.W.2d 51 (1980) (the plaintiff was the drawer); *Mid-Atlantic Tennis Courts, Inc. v. Citizens Bank and Trust Co. of Md.*, 658 F. Supp.140 (D. Md. 1987) (the plaintiff was the named payee); *Bullitt County Bank v. Publishers Printing Co., Ky.*, 684 S.W. 2d 289 (1984) (the plaintiff was the drawer); *Lewis v. Telephone Employees Credit Union*, 87 F.3d 1537 (9<sup>th</sup> Cir. 1996) (the plaintiff was the drawer). The plaintiffs cited only one case involving a fraudulently endorsed cashier's check in which the plaintiff was not the drawer or payee, see *Kelly v. Central Bank and Trust Co. of Denver*, 794 P.2d 1037,1042 (Colo. Ct. App. 1989), but that case was decided prior to the 1996 amendments to the UCC, codified in KRS 355.3-420, that established that only a payee to whom the check was delivered has standing to sue for its conversion.

Nevertheless, the Peoples Bank defendants concluded their argument with the somewhat paradoxical point that the denial of the plaintiffs' summary judgment motion and the granting of the Peoples Bank defendants' summary judgment motion would not mean that the plaintiffs will be left with no immediate relief. To the contrary, the Peoples Bank defendants argued, the reasons they offered for denying summary judgment to the plaintiffs and granting it to the Peoples Bank defendants also led to the conclusion that the plaintiffs were entitled to immediate release of the construction liens on their property. That was because, in the Peoples Bank defendants' view, the record was undisputed that the closing agents had constructively delivered the payoff funds to the construction lenders at closing, and therefore, those lenders had the obligation under KRS 382.365 to release their liens within thirty days of satisfaction thereof. That statute provides, in pertinent part, that "[a] holder of a lien on real property . . . shall release the lien in the county clerk's office where the lien is recorded within thirty (30) days from the date of satisfaction."<sup>11</sup>

The Peoples Bank defendants contended that constructive delivery was established in either of two ways. First, constructive delivery to the construction lender occurred when the closing agent transferred title to the plaintiff purchaser. Under the law of escrows, an escrow agent (here, the closing agent) acted as the agent for the depositor of the money until the condition for transfer of that money is satisfied.<sup>12</sup> Once the condition is satisfied, the escrow

---

<sup>11</sup>KRS 382.365(1).

<sup>12</sup>*Equisource Realty Corp. v. Crown Life Ins. Co.*, 854 S.W.2d 691, 697 (Tex.App. 1993).



agent took off his hat as agent for the depositor, putting on his hat as agent for the recipient of the money.<sup>13</sup>

In the context of the real estate closings at issue, the closing agent acted as the agent for the mortgagee (*i.e.*, the construction lender), who was the payee of a payoff check delivered into escrow once all of the closing conditions are satisfied.<sup>14</sup> According to the Peoples Bank defendants, the condition for transfer of the money – *i.e.*, transfer of title to the real estate – was satisfied at closing. Therefore, the payoff proceeds were constructively delivered to the construction lender through the closing agent's receipt of that money.

The second argument advanced by the Peoples Bank defendants for constructive delivery was that such delivery was effected when the closing agent delivered the payoff check to Erpenbeck's representative at the closing. For example, one of the construction lenders had stated in its pleadings that "the Closing Agents delivered the payoff checks to Erpenbeck or the Erpenbeck Companies' agents or employees as express or implied agents for the First Lenders

---

<sup>13</sup>*Mott v. Lombard*, 655 A.2d 362, 364 (Me. 1995).

<sup>14</sup>*Drusco v. Bank One of Columbus*, 705 N.E.2d 717, 722 (Ohio App. 1997) (holding that "placing the deposit in the possession of the [closing agent] for the use of [the payee] constituted constructive possession on [the payee's] behalf, as [the closing agent] had no authority to do otherwise than deliver the check to [the payee]" upon the happening of a condition.). As one court explained,

a constructive delivery of an instrument held in escrow occurs when all the conditions of the escrow have been met. Thereafter the escrow holder ceases to be the agent for both parties and becomes the agent for each party in respect to the things placed in escrow to which each party has become completely entitled.

*Mott*, 655 A.2d at 364 (citing 28 Am.Jur.2d *Escrow* § 28); see also *Todd v. Vestermark*, 302 P.2d 347, 377 (Cal. Ct. App. 1956) ("The escrow holder is agent for both parties at all times prior to performance of conditions of the escrow, but when that even transpires . . . the nature of this dual agency changes to an agency not for both but for each of the parties to said transaction in respect to those things placed in scrow to which each has thus become completely entitled"); *Burford v. Bridwell*, 185 P.2d 216, 218 (Okl. 1947) ("Generally the depository is the agent or trustee of both parties until performance of the condition, but thereafter he holds the instrument as agent for the party entitled thereto.").

[i.e., the construction lenders].”<sup>15</sup> The Peoples Bank defendants argued that there was evidence that the construction lenders in fact recognized Erpenbeck’s representative as their agent for acceptance of payoff checks by virtue of their having not objected to Erpenbeck’s representative serving in that capacity in other closings. Notwithstanding that Erpenbeck’s representative was a wrongdoer, that did not preclude a finding that Erpenbeck’s representative was an agent of the construction lenders, the Peoples Bank defendants argued. Indeed, they cited to case law in which a wrongdoer such as an embezzler or thief has been deemed to be the agent of a principal who is the payee on a check, resulting in a ruling that the check was delivered to the payee when it was obtained by the wrongdoer.<sup>16</sup>

The Peoples Bank defendants concluded that because there was constructive delivery of the payoff funds to the construction lenders, those lenders had an obligation under KRS 382.365(1) to immediately release the liens. To accomplish the release of the liens, the Peoples Bank defendants requested the Court to declare, as part of its summary judgment ruling, that there was constructive delivery of the payoff funds to the construction lenders and therefore immediate release of the liens was required.

---

<sup>15</sup> Answer and Counterclaim of PNC Bank, N.A. ¶ 1, served May 31, 2002, in *Peoples Bank of Northern Ky. v. Erpenbeck*, Case No. 02-CI-719.

<sup>16</sup> See, e.g., *Humberto Decorators, Inc. v. Plaza Nat’l Bank*, 434 A.2d 618, 620 (N.J. Super. 1981) (holding that a payee could bring an action for conversion under the Uniform Commercial Code because the payee received constructive delivery of the check when the drawer gave a third party (thief) the check for delivery to the payee and the payee expected that the third party would deliver the check).

### ***The Plaintiffs' Other Claims and the Peoples Bank Defendants' Responses***

Although no party moved for summary judgment on the plaintiffs' fraud and negligence claims against the Peoples Bank defendants, the plaintiffs' likelihood of success on those claims was addressed in the briefing of a motion made by the plaintiffs in response to a foreclosure action commenced by one of the construction lenders.<sup>17</sup>

#### ***Fraud***

The plaintiffs based their fraud claim on allegations that the plaintiff class "reasonably relied on Defendant Peoples [Bank]'s representations that it would follow banking laws and traditions when it received checks and/or drafts" and that "[d]efendant Peoples [Bank] intentionally and recklessly disregarded its representations and duties by failing to deliver the proceeds of the check and drafts to the entities identified as the payee and by intentionally and/or recklessly failing to follow the restricted endorsements contained on the checks and drafts."

The Peoples Bank defendants disputed that these allegations stated any cognizable fraud claim and emphasized the named plaintiffs' deposition testimony which, according to the Peoples Bank defendants, precluded as a matter of law any finding of fraud. The Peoples Bank defendants argued that they could not have committed any fraud because the named plaintiffs, by their own admission, had never had any contact with Peoples Bank and knew of no class member who had had any contact with Peoples Bank either. For example, when the husband of a married couple who were the named plaintiffs was asked if he was aware of any fraudulent statement or

---

<sup>17</sup>See Class Plaintiffs' Request and Motion for Emergency Protection Against Foreclosure Actions (filed June 13, 2002).

communication made by Peoples Bank to him or his wife, he replied, "Not aware of, no."<sup>18</sup> Similarly, his wife testified that she was not aware of any false statement ever made to her or her husband by anyone at Peoples Bank.<sup>19</sup> In fact, the named plaintiffs admitted that they had never done any banking at Peoples Bank, that no one representing Peoples Bank attended their closing, that Peoples Bank was never discussed at the closing, that they were not aware at their closing that any Erpenbeck company had an account at Peoples Bank, and that they have never had a conversation with anyone at Peoples Bank about the issues relating to the closing on their property.<sup>20</sup> Based on this record, the Peoples Bank defendants argued that it is uncontroverted by the named members of Plaintiffs' class, that Peoples Bank made no fraudulent statement to them about anything at any time.<sup>21</sup>

### *Negligence*

The plaintiffs also argued that the Peoples Bank defendants were negligent based on Peoples Bank's acceptance of the payoff checks for deposit that were not payable to the account owner. The Peoples Bank defendants did not dispute that these deposits had occurred, but argued

---

<sup>18</sup>Deposition of Charles Mitchell, June 3, 2002 ("C. Mitchell Depo."), at 11.

<sup>19</sup>See Deposition of Sherry Mitchell, June 3, 2002 ("S. Mitchell Depo."), at 26-27.

<sup>20</sup>See C. Mitchell Depo. at 10-11; S. Mitchell Depo. at 17-18, 26-27.

<sup>21</sup>The Peoples Bank defendants also argued that the named plaintiffs' testimony confirmed that no fraudulent statements were made by the Peoples Bank directors either. The named plaintiffs admitted that they had never met any of the directors, see S. Mitchell Depo. at 63; C. Mitchell Depo. at 49, and acknowledged that the directors had been sued simply because they were directors of Peoples Bank, see S. Mitchell Depo at 64; C. Mitchell Depo. at 49.

that the plaintiffs had no negligence claim because the Peoples Bank defendants owed them no duty of care.<sup>22</sup>

Negligence is generally defined as a lack of due diligence or care.<sup>23</sup> Under Kentucky law, in order to succeed on a claim of negligence, a plaintiff must establish (1) a duty owed to the plaintiff; (2) a breach of that duty; and (3) a causal connection between the breach of the duty and the injury allegedly suffered by the plaintiff.<sup>24</sup> The Peoples Bank defendants argued that where there is no duty owed to the injured party, there can be no negligence action, as “negligence is the antithesis of duty.”<sup>25</sup>

There is Kentucky authority that has taken a fairly broad view of scope of duty in negligence cases. As the Kentucky Court of Appeals observed in *Seigle v. Jasper*:

It is well established that “[t]he concept of liability for negligence expresses a universal duty owed by all to all.” *Gas Service Co., Inc. v. City of London*, 687 S.W.2d 144, 148 (Ky. 1985). “The rule is that every person owes a duty to every other person to exercise ordinary care in his activities to prevent foreseeable injury.” *Grayson Fraternal Order of Eagles v. Claywell*, 736 S.W.2d 328, 332 (Ky. 1987).<sup>26</sup>

In *Seigle* an attorney was held to have a duty to a non-client (the purchasers in a land deal) based on a negligent title opinion.

---

<sup>22</sup>The Peoples Bank defendants also had an argument that the UCC remedies were exclusive and preempted any negligence claim. See *Hancock Bank v. Ensenat*, 2001 WL 1610059 (Miss. Ct. App. 2001) (holding that a payee could only bring a UCC conversion claim and was not permitted to assert claims for negligence against depository bank). UCC Article 4 arguably displaces common law tort claims when it states that it governs “the liability of a bank for action or non-action with respect to an item handled by it for purposes of presentment, payment or collection.”

<sup>23</sup>Haynes, *Kentucky Jurisprudence, Torts*, § 30-2 (1988).

<sup>24</sup>*Lewis v. B&R Corporation*, Ky. App., 56 S.W.3d 432, 437 (2001).

<sup>25</sup>*Louisville & N.R. Co. v. Seeley's Adm'r.*, Ky., 202 S.W. 638, 640 (1918).

<sup>26</sup>*Seigle v. Jasper*, Ky. App. 867 S.W.2d 476, 481(1993).

The Peoples Bank defendants cited to cases holding that a "bank owes no duty of care to a noncustomer with whom it has no relationship."<sup>27</sup> Their rulings were based on the premise that when there is no privity between the parties, a bank will owe the stranger no duty of vigilance.<sup>28</sup> As one example, the Peoples Bank defendants offered *Bank Polska Kasa Opieki, S.A. v. Pamrapo Savings Bank, S.L.A.*,<sup>29</sup> in which the court dismissed with prejudice a drawer's claim for negligence against a depository bank that had accepted a fraudulently indorsed check. In so holding, the court found that the depository bank could not be liable for negligence to the drawer of the fraudulently endorsed check because "as a depository bank, [the depository bank] had no direct dealings with [the drawer] and owed it no duty."<sup>30</sup> The Peoples Bank defendants contended that if a depository bank owes no duty to the drawer of a check, whose name appears on the check, then it follows that parties such as the plaintiff purchasers, whose names appeared nowhere on the payoff checks at issue, were owed no duty by Peoples Bank, the depository bank.

---

<sup>27</sup>*Volpe v. Fleet Nat. Bank*, 710 A.2d 661, 664 (R.I. 1998). See also *Miller-Rogaska, Inc. v. Bank One, Texas, N.A.*, 931 S.W.2d 655, 663 (Tex. App. 1996) (finding that a bank was not negligent because it does not owe a duty of care to a fraudulently endorsed check's payee because the payee was not a customer of the bank); *Roy Supply, Inc. v. Wells Fargo Bank, N.A.*, 46 Cal. Rptr.2d 309, 325 (Cal. App. 1995) (holding that a bank's duty of care arises by contract between a bank and its customer); *Pennsylvania National Turf Club, Inc. v. Bank of West Jersey*, 385 A.2d 932, 936 (N.J. Super. 1978) (ruling that "the drawee bank herein had no duty arising out of a relationship to the holder of the check which could ripen into tort liability [because there was an] absence of evidence of any agreement, undertaking or contact between plaintiff and defendant from which any special duty can be derived. . . .").

<sup>28</sup>*First Nat. Bank of Washington v. Whitman*, 94 U.S. (4 Otto) 343, 344-45 (1876); *Baltimore & O.R. Co. v. First National Bank of Alexandria*, 47 S.E. 837 (Va. 1904).

<sup>29</sup>909 F. Supp. 948, 956 (D.N.J.1995).

<sup>30</sup>*Id.* (citing *Western Union Tel. Co. v. Peoples Nat. Bank in Lakewood*, 404 A.2d 1178 (N.J. Super. App. Div. 1979); *Stone & Webster Engineering Corp. v. First Nat. Bank & Trust of Greenfield*, 184 N.E.2d 358, 364 (1962)).

The proof cited by the Peoples Bank defendants on this point included the named plaintiffs' admissions that they had never been customers of Peoples Bank,<sup>31</sup> and there was no evidence that any other class member had a customer relationship with Peoples Bank. The Peoples Bank defendants further noted that Peoples Bank had no representative at the named plaintiffs' closing, the named plaintiffs had never had any communications with anyone at Peoples Bank regarding the closing, and there was no evidence that the other class members' experiences were any different in this regard.<sup>32</sup> According to the Peoples Bank defendants, the absence of proof of privity or any relationship between the plaintiff class and Peoples Bank established that Peoples Bank owed the plaintiff class no duty, and thus their negligence claim would not succeed.

#### ***Possible Scenarios***

If *Mitchell* had proceeded to trial and final adjudication, how might the final outcome have looked? Two of the possible scenarios are discussed below.

#### ***Construction Lenders v. Peoples Bank v. Everyone Else***

If the Peoples Bank defendants were correct that the plaintiff-purchaser's payment to the closing agent of the home purchase price, or the closing agent's delivery of the construction loan payoff check to Erpenbeck's agent, constituted constructive delivery to the construction lender, then the lender would seemingly have been obligated to release the lien. But would the construction lender (having released a lien for which payment had been stolen by Erpenbeck)

---

<sup>31</sup>S. Mitchell Depo. at 26; C. Mitchell Depo. at 11.

<sup>32</sup>S. Mitchell Depo. at 10-11; S. Mitchell Depo. at 17-18, 27.

then be the one to bear all of the loss (assuming there were no assets available from Erpenbeck and his companies to pay a judgment)?

As the payee on the check deposited into Erpenbeck's account, a construction lender might have argued that it had a conversion claim against Peoples Bank, the depositary institution. KRS 355.3-420 does allow a claim by a payee who received delivery "through delivery to an agent." The construction lender could have argued that this condition was satisfied by virtue of constructive delivery as discussed above, and could have relied upon authority cited by the plaintiffs for the proposition that a payee with constructive delivery of a check has standing to sue the depositary bank for accepting the check for deposit with the payee's endorsement.<sup>33</sup>

The construction lender also might have argued for recovery against the Peoples Bank defendants based on negligence. As with the plaintiffs' negligence claim discussed above, the critical issue for the construction lender's negligence theory would have been whether Peoples Bank, the depositary bank, owed any duty to the construction lender, which was a non-customer of the depositary bank. There is authority that could be read to support either an affirmative or negative answer to that question.<sup>34</sup>

In response to either a conversion or negligence claim brought by a construction lender, the Peoples Bank would have sought contribution and apportionment against other third parties,

---

<sup>33</sup>See, e.g., *Humberto Decorators, Inc. v. Plaza Nat'l Bank*, 434 A.2d 618 (N.J. Super Ct. 1981).

<sup>34</sup>Compare *Volpe v. Fleet Nat'l Bank*, 710 A.2d 661, 664 (R.I. 1998) (under Rhode Island law, a depositary bank owes no duty of care to non-customer payee of a check whose indorsement was forged) with *In re McMullen Oil Co.*, 251 B.R. 558 (U.S. Bkt. C.D. Cal. 2000) (under California law, a depositary bank may in certain circumstances owe a duty to a non-customer not to accept for deposit a check with an obviously missing endorsement).



including Erpenbeck and his companies (based on their fraud) and the closing agents (based on negligence).<sup>35</sup>

---

<sup>35</sup> According to the Peoples Bank defendants, they would have been entitled to contribution and apportionment even though conversion is an "intentional" tort. They cited *Roman Catholic Diocese of Covington v. Sector*, Ky. App., 966 S.W.2d 286 (1988), for the proposition that under KRS 411.182, apportionment may be appropriate even as to intentional torts.

***Construction Lender v. Homeowner and Homeowner's Lender v. Everyone Else***

Another scenario that could have occur had the *Mitchell* case not settled would have been for many or all of the construction lenders to bring foreclosure actions naming the homeowner and the homeowner's lender as defendants. This, in fact, did occur with respect to one property, but the case was settled before the legal claims were litigated.<sup>36</sup> Had such a foreclosure action been played out in court, the homeowner and the homeowner's lender may have defeated it on the ground that there was constructive delivery of the payoff check to the construction lender (and therefore the construction lender had no valid lien on the property). If, however, it was found that no constructive delivery occurred, then the construction lender would have proceeded to foreclose on the property, in which case, the homeowner's lender would have made a claim on the title insurance company, based on the title insurance policy purchased by the homeowner's lender in conjunction with the closing, to pay off the construction lender's lien. Assuming it paid off the construction lien, the title insurance company then would have been subrogated to the rights of its insured (*i.e.*, the homeowner's lender) and probably would have made a claim against the closing agent for negligence and breach of contract based upon the closing agent's failure to arrange for proper delivery of the original payoff check to the construction lender.

The closing agent (the drawer of the original payoff check) probably would have responded by making a claim against the closing agent's bank (the drawee) under UCC § 4-401 (KRS 355.4-401).<sup>37</sup> Under 4-401, the drawee may not collect from the drawer for items that are

---

<sup>36</sup>See *Guardian Savings Bank, FSB v. Erpenbeck & Kennedy Builder, LLC*, Case No. 02-CI-319 (Boone County Circuit Court).

<sup>37</sup>The closing agent might have attempted to bring claims directly against Peoples Bank. However, because the closing agent was the drawer of the diverted payoff check, a conversion claim against Peoples Bank would have been precluded by UCC § 3-420 (KRS 355.3-420), which excludes standing for a drawer to claim conversion

not properly payable from the drawer's account. Thus, the closing agent would seek to recover from the drawee bank the amount of the diverted payoff check, which the closing agent would claim had been improperly debited from the closing agent's account by the drawee bank and paid to the depository bank (Peoples Bank).

In response to the closing agent's 4-401 claim, the drawee bank probably would have raised a defense of the closing agent's negligence under UCC § 3-406 (KRS 355.3-406), which provides:

(a) A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or in the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.

(b) Under subsection (a), if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.

(c) Under subsection (a), the burden of proving failure to exercise ordinary care is on the person asserting the preclusion. Under subsection (b), the burden of proving failure to exercise ordinary care is on the person precluded.

Based on this provision, the drawee bank would have probably argued that it paid the instrument in good faith, that the closing agent's negligence substantially contributed to the making of the "forged" signature on the diverted payoff check, and therefore the drawee bank should have no liability.

---

against the depository bank. Also, the drawer has no presentment warranty claim against the depository bank under 3-417. See Official Cmt. 2 to UCC 3-417 (stating that current version of 3-417 provides no warranty right to a drawer, overruling *Sun 'N Sand, Inc. v. United California Bank*, 582 P.2d 920 (Cal. 1978)). Any negligence claim by the closing agent against Peoples Bank would have relied upon an expansive definition of duty of care similar to that espoused by the plaintiffs in the *Mitchell* case, assuming that the closing agent was not a customer of Peoples Bank. Contributory negligence, of course, would have been raised as a defense by Peoples Bank to any negligence claim brought by a closing agent.

There is, however, some question as to whether 3-406 applies to situations where there is a missing or restrictive indorsement (as was the case for the homeowners in *Mitchell*), which could be argued is not a “forged” signature within the meaning of 3-406. The courts are split on this issue. Some cases have held that a 3-406 defense is not available to the drawee bank where there is missing or restrictive indorsement.<sup>38</sup> Other authority seems to support the proposition that 3-406 applies to situations involving a depository bank’s taking of checks with missing endorsements.<sup>39</sup>

---

<sup>38</sup>See, e.g., *Norman Goldstein Assocs., Inc. v. Bank of New York*, 611 N.Y.S.2d 276, 278 (S. Ct., App. Div., 2d Dept. 1994) (“In addition, we find that the trial court was correct in finding that the negligence defense provided by UCC 3-406 is unavailable to BNY on the second and sixth causes of action. That statute requires that there first exist a signature endorsing the check and that it be an unauthorized signature, whereas he the three checks lacked any signature or endorsement whatsoever.”)

<sup>39</sup>In *Kuwait Airways Corp. v. American Security Bank*, 890 F.2d 456 (D.C. Cir. 1989), the court specifically examined this question:

[The Drawer] further contends that section 3-406 does not apply where the payee’s indorsement is missing. However, where, as in this case, we assume that the absence of any indorsement is a ‘forged indorsement’ within the meaning of section 3-419(1)(c), we must apply a similar reading to the term ‘unauthorized signature in 3-406. Cf. *Empire Moving & Warehouse Corp. v. Hyde Park Bank & Trust Co.*, 43 Ill. App.3d 991, 2 Ill.Dec. 753, 757, 357 N.E.2d 1196, 1200 (1976)(applying section 3-406 where bank took checks without required endorsements).

*Id.* at 463; accord *Arkwright Mutual Insurance Co. v. State Street Bank & Trust Co.*, 703 N.E.2d 217 (Mass. 1998).

The court in *John Hancock Financial Services v. Old Kent Bank*, 185 F.Supp. 771 (E.D. Mich. 2002), however, question the *Kuwait* court’s interpretation of the phrase ‘unauthorized signature’ as used in 3-406 prior to the 1993 amendment to the UCC. Although not specifically ruling that a bank may not use § 3-406 when it has deposited in an account a check missing an indorsement, the *John Hancock Financial Services* court stated that “the 1993 amendments to the UCC, as adopted in Michigan, indicate that the preclusion defense is not available in every conversion case and that these provisions should be treated separately. . . . the amended version of [§ 3-406] limits the preclusion defense to instances in which ‘an alteration for the instrument’ or ‘making of a forged signature’ occurs.” *Id.* at 777. Furthermore, the court stated,

Comment to 1 [§ 3-420] supports the argument that the preclusion defense is not available in every conversion case. While concluding that both examples are conversion under [ § 3-420], Comment 1 makes a distinction between payment on a check with a ‘forged’ indorsement and payment on a check with a missing indorsement. This distinction supports that argument that these are two separate examples of conversion. Because [§ 3-406] only pertains to ‘forged

In addition to its potential 3-406 defense against the closing agent's (*i.e.*, drawer's) claim, the drawee bank would probably have brought a claim of breach of presentment warranty against the depositary bank (Peoples Bank) under UCC 4-208 (KRS 355.4-208). Under 4-208, a depositary bank who presents the check for payment to the drawee bank warrants to the drawee that the depositary bank is a person entitled to enforce the draft. The drawee bank likely would have argued that Peoples Bank was not a "person entitled to enforce" the payoff check, as defined in 3-301, by virtue of having acquired the check from Erpenbeck, and therefore Peoples Bank is liable under its 4-208 warranty.

Liability under 4-208, however, is also limited by the defense under 4-208(c). This provision states that "if a drawee asserts a claim for breach of warranty based on an unauthorized indorsement of the draft or an alteration of the draft, the warrantor may defend by proving that . . . the drawer is precluded under Section 3-406 [Negligence Contributing to Forged Signature or Alteration of Instrument] or 4-406 [Customer's Duty to Discover and Report Unauthorized Signature or Alteration] from asserting *against the drawee* the unauthorized indorsement or alteration." (emphasis added) This section permits a depositary bank to limit its liability by showing that the drawee has a valid defense under 3-406. Thus, Peoples Bank, as the depositary bank, would only be liable to the drawee bank to the extent that the drawee is liable to the drawer (*i.e.*, the closing agent) under 4-401 (after application of the 3-406 defense described above).

---

signatures' and 'altered instruments' it, logically, does not cover every act of conversion included in [§ 3-420]. Therefore, the scope of these provisions are not 'coextensive.'

Peoples Bank would have argued that because the closing agents, the drawers, were negligent by entrusting the payoff checks to Erpenbeck's representative for delivery and that negligence was a substantial factor in the subsequent loss, the closing agents may not assert a right against their drawee bank *unless* the closing agents could have proved that the drawee banks were also negligent in paying the diverted payoff checks. Peoples Bank would have contended that the drawee banks themselves were not negligent, so the drawers were precluded from making claims against the drawee banks because of the 3-406 defense. The upshot of Peoples Bank's argument, if it had been accepted by the court, would have been that the closing agents and title insurance companies would have borne much, and perhaps all, of the loss caused by Erpenbeck's fraud.

#### ***How the Case Was Resolved***

None of the claims discussed above were ruled upon by the court because of a settlement reached by the Peoples Bank defendants with the *Mitchell* homeowner-plaintiffs. The Peoples Bank defendants paid approximately \$16.8 million to secure releases of the construction liens, and then negotiated settlements with dozens of closing agents, title insurance companies and construction lenders for each to pay Peoples Bank a share of this amount based upon the number of closings with which they were involved.

The *Mitchell* case presented quite exigent circumstances that called for relatively speedy resolution: namely, some 210 homeowners who, through no fault of their own, had unreleased first liens on their property held by construction lenders that prevented the homeowners from selling or refinancing. Although the legal theories set forth above would have ultimately

resolved the matter, the practicalities of the situation demanded a settlement that would provide expeditious relief for the homeowners from the unreleased liens, but also equitably distribute the loss among all of the parties involved.





# **STATE PREDATORY LENDING AND OCC PREEMPTION**

*Caryn F. Price  
Wyatt, Tarrant & Combs, LLP  
Louisville, Kentucky*

Copyright 2004. Caryn F. Price. All Rights Reserved.

## **SECTION D**



## **STATE PREDATORY LENDING AND OCC PREEMPTION**

<b>PREDATORY LENDING: WHAT IS IT? .....</b>	<b>D-1</b>
<b>EXAMPLES OF PREDATORY LENDING .....</b>	<b>D-1</b>
<b>RISKS TO FINANCIAL INSTITUTIONS ASSOCIATED WITH PREDATORY LENDING PRACTICES .....</b>	<b>D-2</b>
<b>WHAT HAVE STATES DONE TO ADDRESS THE PERCEIVED PROBLEM OF PREDATORY LENDING? .....</b>	<b>D-4</b>
<b>STEPS THE OCC HAS TAKEN TO PREVENT PREDATORY LENDING PRACTICES .....</b>	<b>D-8</b>
<b>EFFECT OF THE OCC'S PREEMPTION RULES ON STATE PREDATORY LENDING LAWS .....</b>	<b>D-10</b>
<b>REACTION AND RECENT DEVELOPMENTS .....</b>	<b>D-12</b>
<b>KENTUCKY'S HIGH-COST HOME LOAN ACT .....</b>	<b>D-15</b>

## **SECTION D**



## STATE PREDATORY LENDING AND OCC PREEMPTION

April 2004

By:  
Caryn F. Price  
Wyatt, Tarrant & Combs, LLP  
Louisville, Kentucky

### **Predatory Lending: What is it?**

A fundamental characteristic of predatory lending is the aggressive marketing of credit to prospective borrowers who simply cannot afford the credit on the terms being offered. Typically, such credit is underwritten predominantly on the basis of the liquidation value of the collateral, without regard to the borrower's ability to service and repay the loan according to its terms, absent resorting to the collateral.

### **Examples of Predatory Lending:**

*Equity stripping* - Typically involves making loans with excessively high, up-front fees that are financed and secured by the borrower's home, often with an excessively high penalty upon prepayment of the loan, for the sole or primary objective of stripping the borrower's home equity.

*Loan flipping* - Frequent refinancings that result in little or no economic benefit to the borrower and are undertaken with the primary or sole objective of generating additional loan fees, prepayment penalties and fees from the financing of credit-related products.

*Refinancings of special subsidized mortgages* - Special subsidized mortgages are often originated under programs sponsored by governmental or nonprofit organizations and generally contain below-market or other nonstandard terms beneficial to the borrower. The refinancing of such loans generally entails the loss of one or more of the beneficial loan terms.

*Disadvantageous loan terms or structures* - Using loan terms or structures, such as negative amortization, to make it more difficult or impossible for borrowers to reduce or repay their indebtedness.

*Balloon payments* - Balloon payments may be used to conceal the true burden of the financing and to force borrowers into costly refinancing transactions or foreclosures.

*Targeting of inappropriate or excessively expensive credit products* - The targeting of inappropriate or excessively expensive credit products to older borrowers, to persons who are not financially sophisticated or who may be otherwise vulnerable to abusive practices and to persons who could qualify for mainstream credit products and terms.

*Inadequate disclosure* of the true costs, risks and appropriateness to the borrower of loan transactions.

*Single premium credit life insurance* - The financing of single premium credit life insurance purchased by the borrower to repay the lender in the event the borrower dies.

*The use of mandatory arbitration clauses* - Mandatory arbitration clauses may serve to insulate unfair and deceptive practices from effective review and relegate consumers to a forum where they cannot obtain injunctive relief against wrongful practices, proceed on behalf of a class, or obtain punitive damages.

### **Risks to Financial Institutions Associated with Predatory Lending Practices.**

*Safety and soundness concerns:*

*The departure from fundamental principles of loan underwriting* increases the risk to the bank that the loan will default and may also increase the bank's potential loss exposure upon default.

*Banks may run the risk of losing a source of funding for operations*, thereby exposing themselves to greater default risk and risk of loss. Access to the secondary market may be effectively foreclosed. Major government sponsored entities active in the secondary market for

mortgage loans have taken a number of affirmative steps to reduce the possibility that they will purchase abusive loans, including a refusal to purchase loans

- in which the lender has not adequately determined the borrower's ability to repay the debt,
- which are subject to the Home Ownership and Equity Protection Act (HOEPA),
- with points and fees in excess of 5% of the loan amount, except in cases where a higher amount of fees was justified to prevent the loan from being unprofitable, and
- in which a prepaid single premium credit insurance policy was included in the amount financed.

*Violations of the FTC Act.* Predatory lending practices may be indicative of unfair or deceptive practices that violate Section 5 of the FTC Act.

- Practices may be found to be deceptive if there is a representation, omission, act, or practice that is likely to mislead, the act or practice would be likely to mislead a reasonable consumer, and the representation, omission, act or practice is likely to mislead in a material way.
- Practices may be found to be unfair if the practice causes substantial consumer injury, such as monetary harm, the injury is not outweighed by benefits to the consumer or to competition and the injury caused by the practice is one that consumers could not reasonably have avoided.

*Violations of Other Laws.* Predatory lending practices may also violate HOEPA or may involve unlawful discrimination.

*CRA Evaluations and Ratings May be Impacted.* Abusive lending practices that evidence illegal practices may adversely affect an institution's CRA performance.

### **What have states done to address the perceived problem of predatory lending?**

Nearly half of the states have passed legislations to curb abusive lending.

*Kentucky's High-Cost Home Loan Statute.* Effective June 24, 2003, Kentucky adopted a new statute, KRS 360.100, which applies solely to "high-cost home loans," i.e.,

- a loan (other than an open end credit plan or reverse mortgage transaction) the principal amount of which is greater than \$15,000 and not more than \$200,000,
- made to a natural person for personal, family or household purposes,
- that is secured by a mortgage on residential real property or collateral which has a mortgage on such property, which is or will be occupied by the borrower as his or her principal dwelling, and
- which, at the time the loan is consummated, without regard to whether the loan transaction is a "residential mortgage transaction" under 12 C.F.R. 226.2(a)(24), is considered a "mortgage" under Section 152 of the Home Ownership and Equity Protection Act of 1994, 15 U.S.C. Sec. 1602(aa) and the regulations promulgated thereunder, as each is amended from time to time.

*The statute adopts the federal thresholds to define "high-cost" loans* - 8% for first lien loans, and 10% for subordinate lien loans, over the yield on U.S. treasury securities of comparable maturities, and \$400 in points and fees, adjusted annually.

*The statute provides broad coverage of mortgage loans with connections to Kentucky* - The statute covers loans where: a lender agrees in Kentucky to lend to Kentucky residents secured by real property in Kentucky; a borrower accepts an offer in Kentucky, or makes an offer in Kentucky to borrow, including solicitations originating outside Kentucky, but received in Kentucky by a Kentucky resident; and a borrower receives an oral or written offer, acceptance, solicitation or communication to lend or borrow in Kentucky.



*The statute prohibits 16 abusive practices:*

- prepayment penalties
- discretionary acceleration
- balloon payments
- negative amortization
- default interest rates
- limits advance payments
- limits refinance fees
- making of loans unless the lender reasonably believes that the borrower will be able to make the scheduled payments to repay the loan based upon consideration of income, obligations, employment and other financial resources
- direct payments to home improvement contractors
- single-premium credit insurance
- unfair arbitration
- limits late fees
- notice of right to cure
- recommendations of default
- charges for payoff statements
- refinancings of below-market loans

*Required Disclosures.* Prior to a lender making a high-cost loan, the lender must provide certain prescribed disclosures to the borrower. In addition, the lender must make available an

educational video, approved by the KDFI, explaining the borrower's rights and responsibilities under the statute.

*Defenses for good faith or inadvertent violations.*

A lender who in good faith fails to comply with the statute will not be deemed to be in violation if it makes appropriate restitution within 30 days and adjusts the loan so that it is in compliance or is no longer a high-cost home loan.

Compliance failures resulting from unintentional and bona fide clerical calculations, computer programming or printing errors may not result in a violation if the lender, within 60 days after discovery of the error, notifies the borrower, make appropriate restitution and adjusts the terms of the loan in a manner beneficial to the borrower so that the loan is in compliance or is no longer a high-cost home loan.

*Other State Laws.* Indiana recently passed the Indiana Home Protection Act. The legislation identifies certain practices that are so inherently abusive that they are prohibited for all loans. In addition, the legislation limits certain additional practices when they are used in a "high-cost" home loan. A "high-cost" home loan is defined in the Act as a home mortgage loan that exceeds either

- the interest rate threshold established by federal law (8 points above the yield on Treasury bills with comparable term for first liens; 10 points above for subordinate liens), or
- points and fees that exceed 5 percent of the total loan amount for loans \$40,000 and above, and 6 percent of the total loan amount for smaller loans.

Under the Home Protection Act, the following acts and practices are prohibited for all home loans:

- financed single-premium credit life insurance and debt cancellation agreements;
- recommendation of default;

- debt acceleration at the sole discretion of the creditor;
- charging the consumer a fee to receive a balance due statement;
- deceptive acts;
- discrimination on the basis of race, color, religion, national origin, sex, marital status or age.

Under the Home Protection Act, the following acts and practices are prohibited for "high-cost" loans:

- financing of fees or charges;
- excessive prepayment penalties;
- financing of life or health insurance;
- loan flipping;
- balloon payments;
- negative amortization;
- increased interest rate after default;
- advance payments made from loan proceeds;
- lending without a referral for homeownership counseling;
- lending without due regard to repayment ability;
- certain predatory home-improvement contracts;
- modification or deferral fees;
- lending without full disclosure of the risks of high-cost loans;

- mandatory arbitration.

**Steps the OCC has taken to prevent predatory lending practices.**

*“We know that it’s possible to deal effectively with predatory lending without putting impediments in the way of those who provide access to legitimate subprime credit... We believe a far more effective approach would be to focus on the abusive practitioners, bringing to bear our formidable enforcement powers where we find abusive practices.”* Comptroller of the Currency John D. Hawke, Jr., July 24, 2003

In 2003, the OCC issued two advisory letters containing guidelines to assist national bank efforts to prevent predatory and abusive lending practices in connection with direct loan originations and with broker and third-party originations.

*Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices* (OCC Advisory Letter 2003-2).

- Advises national banks and their operating subsidiaries to take appropriate steps to ensure that they do not become involved in predatory lending
- Advises national banks to adopt policies and procedures to ensure that an appropriate determination has been made that a borrower has the capacity to make scheduled payments to service and repay the loan. A loan that has been based on the foreclosure value of the collateral, rather than on the borrower’s ability to repay the loan without resort to the collateral, is fundamentally a predatory loan and is inconsistent with safe and sound banking practices.
- Advises national banks to adopt policies and procedures to specify whether and under what circumstances they will make loans involving features that have been associated with abusive lending practices, such as: frequent, sequential loan refinancings; refinancings of special subsidized mortgages that contain terms favorable to the borrower; balloon payments; prepayment penalties that are not limited to the early years of the loan; interest rate increases upon default; the financing of points and fees; single premium credit life insurance; and mandatory

arbitration clauses. Such policies should be adequate to avoid the risk that a transaction could be deemed to involve unfair or deceptive practices.

- Advises national banks to adopt policies and procedures that reflect the degree of care that is appropriate to the risk of a transaction, including consideration of how the loan meets the borrower's particular financial circumstances and needs.
- Encourages national banks to adopt procedures that provide for reporting of good credit histories to the major credit reporting agencies.
- Advises national bank to perform loan documentation reviews to ensure that loans comply with applicable laws and the bank's policies.

*Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans* (OCC Advisory Letter 2003-3). Advises national banks to take affirmative steps to address the risk that they may acquire predatory loans through broker and loan purchase transactions, including

- adopting clear procedures for entering into broker and third party originator relationship's that delineate any unacceptable characteristics for loans the bank will acquire
- performing appropriate due diligence before entering into a business arrangement with a broker or third-party loan originator
- developing approved lists of brokers and originators with whom it will do business
- requiring written agreements with third parties that require brokers to abide by bank policies, applicable law and make best efforts to ensure that loans offered are consistent with the borrower's needs, objectives and financial situation
- obtaining written agreements between the borrower and the broker to ensure that the agreement clearly discloses the services the broker will provide and the fees to be paid, contains a specific request by the borrower for the specified services at

that fee and includes a signed and dated acknowledgement of receipt by the borrower

- monitoring broker and third-party loan originators for compliance and taking appropriate corrective action, including modification of loan terms and termination of the business arrangement with the third party

#### **Effect of the OCC's preemption rules on state predatory lending laws.**

On January 7, 2004, the OCC released two final rules clarifying the scope of (i) the preemption of state law available to national banks and their operating subsidiaries and (ii) the OCC's visitorial powers over national banks and their operating subsidiaries. In addition, the OCC adopted anti-predatory lending standards that apply to all consumer loans and not just mortgages or high-cost home loans.

*Preemption Final Rule.* Generally, the rules provides that state laws do not apply to national banks if they obstruct, impair, or condition a national bank's exercise of its federally authorized lending, deposit-taking and other powers.

#### *Types of state laws that are preempted:*

- with respect to all lending: laws that address the licensing, registration, filings or reports by creditors, requiring insurance for collateral or other credit enhancements, loan-to-value ratios, terms of credit, escrow and similar accounts, security property, access to and use of credit reports, disclosure and advertising, disbursements and repayments, interests rates on loans
- with respect to real estate lending: laws that address the amount that may be lent upon security of real estate, processing, originating and servicing mortgages, due-on-sale clauses, covenants to qualify leaseholds as security for real estate loans
- with respect to deposit-taking: laws that address abandoned and dormant accounts, checking accounts, disclosure requirements, saving account orders of

withdrawal, state licensing or registration requirements, special purpose savings services and funds availability

- lists are not intended to be exhaustive and the OCC may identify and address on a case-by-case basis other types of state laws that are preempted

*Types of state laws that are not preempted:*

- laws on contracts, rights to collect debts, acquisition and transfer of property, taxation, zoning, crimes and torts
- any other law that the OCC determines to only incidentally affect national banks' lending, deposit-taking or other operations

*Visitorial Powers Final Rule.* The rule clarifies the extent to which state officials may examine national banks and take actions to enforce their compliance with state or federal laws.

- Provides that “unless otherwise provided by Federal law, the OCC has exclusive visitorial authority with respect to the content and conduct of activities authorized for national banks under Federal law.” This provision was added in order to clarify that the OCC’s exclusive visitorial authority relates only to the banking and related activities of national banks and their operating subsidiaries. States still retain the ability to enforce non-banking related laws, such as fire codes, environmental laws, zoning ordinances, generally applicable criminal laws and the like.
- Clarifies that the exception to the OCC’s exclusive visitorial powers for “visitorial powers...vested in the courts of justice” refers to powers inherent in the judiciary and does not grant state or other governmental authorities any right that they do not otherwise possess to inspect, superintend, direct, regulate or compel compliance by a national bank with any law regarding the content or conduct of activities authorized for national banks under Federal law.

*Anti-Predatory Lending Standards.* As part of the final preemption rule, the OCC adopted anti-predatory lending standards that apply to all consumer loans and not just mortgages or high-cost home loans.

- Prevents a national bank from making a consumer loan (one for personal, family or household purposes) based predominantly on the foreclosure or liquidation value of the collateral without regard to the consumer's ability to repay the loan according to its terms
- Allows a national bank or operating subsidiary to use any reasonable method to determine whether the borrower has the ability to repay the loan without relying on the collateral, including the borrower's current financial obligations, employment status and credit history.
- Prohibits a lender from relying only on the liquidation value of the collateral when the borrower and lender both understand "that it is likely or expected that" the lender will turn to the collateral to repay the debt, as with reverse mortgages.
- Explicitly recognizes that national banks and their operating subsidiaries continue to be subject to applicable federal law and may not engage in unfair or deceptive practices as prohibited under Section 5 of the FTC Act.
- Provides codification of the OCC's authority to target banks engaged in abusive lending practices and makes a violation of such provisions a violation of the banking laws, which could enhance the OCC's enforcement capabilities.

#### **Reaction and Recent Developments.**

*Response of State Attorneys General.* Immediately after promulgation of the final rules, New York's Attorney General issued a press release describing the new rules as "shamefully bad public policy" that represented "an unprecedented expansion of the OCC's powers." On January 16, 2004, he filed a lawsuit in New York State Supreme Court against an operating subsidiary of First Tennessee Bank, a national bank, alleging impropriety in its collection and foreclosure practices.

*OCC Censured by House Financial Services Committee.* On February 25, 2004, the House Financial Services Committee voted to censure the OCC for the OCC regulations. Though the action has no legal force, the committee chastised the OCC for issuing the new rule



without congressional authorization and without clear plans to provide funds for personnel for increased enforcement.

*Statements of Comptroller Hawke to Senate Committee on Banking, Housing and Urban Affairs.* On April 7, 2004, in testifying before the Senate Committee on Banking, Housing and Urban Affairs, Comptroller Hawke expressed concern over the widespread misunderstanding and mischaracterization of the rules. He emphasized that the OCC's preemption regulation

- does not preempt state laws other than those listed,
- does not immunize national banks from complying with a host of state laws,
- does not preempt anti-discrimination laws,
- does not extend to activities authorized for financial subsidiaries of national banks,
- does not impinge on the functional regulation framework set in place in the Gramm-Leach-Bliley Act,
- does not allow national banks to charge higher rates of interest than they previously could, and
- does not authorize any new national bank powers.

*Federal court cites OCC preemption regulations in finding Ohio Retail Installment Sales Act preempted.* The U.S. District Court, Northern District of Ohio found on March 4, 2004, that the National Bank Act and corresponding federal regulations preempt the Ohio Retail Installment Sales Act (Abel v. KeyBank USA, N.A., No. 03 CV 524 (D. Ohio 03/04/04)). The case illustrates the level of deference courts are willing to give the OCC preemption regulations as well as OCC testimony at congressional hearings. The court applied the regulation to conduct that occurred prior to the rule's effective date, consistent with the OCC's position that the regulation is consistent with existing law.

*Query the effect of the OCC's preemption rule on KRS 287.102.* KRS 287.102 provides state banks receiving a CAMEL rating of 1 or 2 at its most recent regulatory examination may engage in any banking activity in which the bank could engage if it was operating as a national bank in any state.

## KENTUCKY'S HIGH-COST HOME LOAN ACT

### KRS 360.100

(1) The following definitions apply for the purposes of this section:

(a) "High-cost home loan" means a loan other than an open-end credit plan or a reverse mortgage transaction in which:

1. The principal amount of the loan is greater than fifteen thousand dollars (\$15,000) and does not exceed two hundred thousand dollars (\$200,000);
2. The borrower is a natural person;
3. The debt is incurred by the borrower primarily for personal, family, or household purposes;
4. The loan is secured by a mortgage on residential real property or secured by collateral which has a mortgage lien interest in residential real property, which is or will be occupied by the borrower as the borrower's principal dwelling; and
5. Without regard to whether the loan transaction is or may be a "residential mortgage transaction" as defined in 12 CFR 226.2(a)(24), as amended from time to time, the loan at the time the loan is consummated is such that the loan is considered a "mortgage" under section 152 of the Home Ownership and Equity Protection Act of 1994, Pub. Law 103-325, 15 U.S.C. § 1602(aa), as the same may be amended from time to time, and regulations adopted pursuant thereto by the Federal Reserve Board, including 12 CFR 226.32, as the same may be amended from time to time.

(b) "Lender" means any person who funds or negotiates the terms of a high-cost home loan or acts as a mortgage broker or lender, finance company, or retail installment seller with respect to a high-cost home loan. However, any person who purchases or is otherwise assigned a high-cost home loan shall be subject to an action for violation of this section only if the violation for which the action or proceeding is brought is apparent on the face of the disclosure or the underlying promissory note.

(2) A high-cost home loan shall be subject to the following limitations:

(a) A high-cost home loan may not contain a provision which permits the lender to charge or collect prepayment fees or penalties more than thirty-six (36) months after the loan closing or which exceed three percent (3%) of the amount prepaid during the first twelve (12) months, two percent (2%) of the amount prepaid during the second twelve (12) months, or one percent (1%) of the amount prepaid during the third twelve (12) months.

(b) A high-cost home loan may not contain a provision which permits the lender, in its sole discretion, to accelerate the indebtedness. This provision does not apply when repayment of the loan has been accelerated by default, pursuant to a due-on-sale provision, or pursuant to some other provision of the loan documents unrelated to the payment schedule.

(c) A high-cost home loan may not contain a scheduled payment that is more than twice as large as the average of earlier scheduled payments. This provision does not apply when the payment schedule is adjusted to the seasonal or irregular income of the borrower.

(d) A high-cost home loan may not contain a payment schedule with regular periodic payments that cause the principal balance to increase.

(e) A high-cost home loan may not contain a provision which increases the interest rate after default. This provision does not apply to interest rate changes in a variable rate loan otherwise consistent with the

provisions of the loan documents, provided the change in the interest rate is not triggered by the event of default or the acceleration of the indebtedness.

(f) A high-cost home loan may not include terms under which more than two (2) periodic payments required under the loan are consolidated and paid in advance from the loan proceeds provided to the borrower.

(g) A lender may not charge a borrower any fees to modify, renew, extend, or amend a high-cost home loan or to defer any payment due under the terms of a high-cost home loan, unless the fees are less than one-half (1/2) of any fees that would be charged for a refinance or unless the borrower is in default and it is in the borrower's best interest.

(h) A lender may not make a high-cost home loan unless the borrower has been provided the following notice or a substantially similar notice, in writing, not later than the time that notice provided by 12 CFR 226.31(c), as amended from time to time, is required:

#### NOTICE TO BORROWER

IF YOU OBTAIN THIS LOAN, THE LENDER WILL HAVE A MORTGAGE ON YOUR HOME. YOU COULD LOSE YOUR HOME AND ANY MONEY YOU PUT INTO IT IF YOU DO NOT MEET YOUR OBLIGATIONS UNDER THE LOAN.

MORTGAGE LOAN RATES AND CLOSING COSTS AND FEES VARY BASED ON MANY FACTORS, INCLUDING YOUR PARTICULAR CREDIT AND FINANCIAL CIRCUMSTANCES, YOUR EMPLOYMENT HISTORY, THE LOAN-TO-VALUE REQUESTED AND THE TYPE OF PROPERTY THAT WILL SECURE YOUR LOAN. THE LOAN RATE AND FEES COULD ALSO VARY BASED ON WHICH LENDER OR BROKER YOU SELECT. YOU SHOULD SHOP AROUND AND COMPARE LOAN RATES AND FEES.

YOU SHOULD ALSO CONSIDER CONSULTING A QUALIFIED INDEPENDENT CREDIT COUNSELOR OR OTHER EXPERIENCED FINANCIAL ADVISOR REGARDING THE RATE, FEES AND PROVISIONS OF THIS MORTGAGE LOAN BEFORE YOU PROCEED. YOU SHOULD CONTACT THE UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT FOR A LIST OF CREDIT COUNSELORS AVAILABLE IN YOUR AREA.

YOU ARE NOT REQUIRED TO COMPLETE THIS LOAN AGREEMENT MERELY BECAUSE YOU HAVE RECEIVED THESE DISCLOSURES OR HAVE SIGNED A LOAN APPLICATION.

REMEMBER, PROPERTY TAXES AND HOMEOWNER'S INSURANCE ARE YOUR RESPONSIBILITY. NOT ALL LENDERS PROVIDE ESCROW SERVICES FOR THESE PAYMENTS. YOU SHOULD ASK YOUR LENDER ABOUT THESE SERVICES.

ALSO, YOUR PAYMENTS ON EXISTING DEBTS CONTRIBUTE TO YOUR CREDIT RATINGS. YOU SHOULD NOT ACCEPT ANY ADVICE TO IGNORE YOUR REGULAR PAYMENTS TO YOUR EXISTING CREDITORS.

(i) A lender may not make a high-cost home loan unless the lender reasonably believes at the time the loan is consummated that one (1) or more of the borrowers, when considered individually or collectively, will be able to make the scheduled payments to repay the loan based upon a consideration of their current and expected income, current obligations, current employment status, and other financial resources, other than the borrower's equity in the dwelling which secures repayment of the loan. A borrower shall be presumed to be able to make the scheduled payments to repay the loan if, at the time the loan is consummated, the borrower's total monthly debts, including amounts owed under the loan, do not exceed fifty percent (50%) of the borrower's monthly gross income as verified by the credit application, the

borrower's financial statement, a credit report, financial information provided to the lender by or on behalf of the borrower, or any other reasonable means. No presumption of inability to make the scheduled payments to repay the obligation shall arise solely from the fact that, at the time the loan is consummated, the borrower's total monthly debts, including amounts owed under the loan, exceed fifty percent (50%) of the borrower's monthly gross income.

(j) If the proceeds of the high-cost home loan are used to refinance an existing high-cost home loan held by the same lender as noteholder, the lender may not directly or indirectly finance:

1. Any prepayment fees or penalties payable by the borrower; or
2. Points and fees, excluding those provided for in 12 CFR 226.4(c)(7), which in the aggregate are in excess of four percent (4%) of the total amount financed.

(k) A lender or mortgage loan broker may not, within one (1) year of the consummation of a high-cost home loan, charge a borrower points and fees in connection with a high-cost home loan if the proceeds of the high-cost home loan are used to refinance an existing high-cost home loan on which points were charged. A lender may not, at any time, charge a borrower points and fees in addition to those allowed by 12 CFR 226.4(c)(7) if the proceeds of the high-cost home loan are used to refinance an existing high-cost home loan, on which points were charged, held by the same lender as noteholder. However, points and fees in accordance with this section may be charged on any proceeds of a high-cost home loan which are in excess of the amount refinanced on the existing high-cost home loan.

(l) A lender may not pay a contractor under a home-improvement contract from the proceeds of a high-cost home loan other than by an instrument payable to the borrower or jointly to the borrower and the contractor, or at the election of the borrower, through a third-party escrow agent in accordance with terms established in a written agreement signed by the borrower, the lender, and the contractor prior to the disbursement.

(m) A lender shall not refinance, replace, or consolidate a zero interest rate or low interest rate loan made by a governmental or nonprofit lender with a high-cost home loan. For purposes of this paragraph, a low interest rate loan is defined as a loan that carries a current interest rate that is two (2) percentage points or more below the current yield on United States Treasury securities with a comparable maturity.

(n) A lender shall not finance single premium credit life, credit accident, credit health, credit disability, or credit loss of income insurance in connection with a high-cost home loan.

(o) A lender shall not make a high-cost home loan unless the lender has made available to the borrower a videotape, or other similar audio-video media format such as DVD or CD, approved by the Department of Financial Institutions, which explains the borrower's rights and responsibilities with regard to this section or high-cost home loans. A lender shall have available for viewing at least one (1) copy of the video in the principal office and each branch office of the lender.

(p) A lender shall not make a high-cost home loan subject to a mandatory arbitration clause that is oppressive, unfair, unconscionable, or substantially in derogation of the rights of consumers. Arbitration clauses that comply with the standards set forth in the Statement of Principles of the National Consumer Dispute Advisory Committee of the American Arbitration Association in effect on the effective date of this Act shall be presumed not to violate this subsection.

(q) A lender shall not charge a late payment fee on a high-cost home loan except in accordance with the following:

1. The late payment fee may not be in excess of five percent (5%) of the amount of the payment past due or ten dollars (\$10), whichever is greater;

2. The late payment fee may only be assessed for a payment past due fifteen (15) days or more; and

3. The late payment fee may only be charged once with respect to a single late payment.

(r) A lender may not charge a borrower a fee in excess of ten dollars (\$10) or actual costs, whichever is greater, per request for a written payoff calculation on a high-cost home loan for the first two (2) requests by a borrower in a calendar year.

(s) A lender shall not initiate a foreclosure or other judicial process to terminate a borrower's interest in residential real property subject to a high-cost home loan without first providing the borrower, at least thirty (30) days prior to the initiation of any process, written notice of default and of the borrower's right to cure. The notice shall include a statement of the amount needed to be paid by the borrower in order to cure the default and the date by which the payment is due to cure the default. If the amount needed to be paid will change during the thirty (30) day notice period, the notice shall provide information sufficient to enable a calculation of the daily change.

(t) A lender shall not recommend or encourage default on an existing loan or other debt in connection with the closing of a high-cost home loan that refinances all or a portion of the existing loan or debt.

(3) Except as provided in paragraph (e) of subsection (2) of this section, the making of a high-cost home loan which violates any provisions of subsection (2) of this section is usurious, subject to the penalties of this chapter, and unlawful as an unfair and deceptive act or practice in or affecting commerce in violation of the provisions of KRS 367.170. The provisions of this section shall apply to any person who in bad faith attempts to avoid the application of this section by:

(a) The structuring of a loan transaction as an open-end credit plan for the purpose and with the intent of evading the provisions of this section when the loan would have been a high-cost home loan if the loan had been structured as a closed-end loan; or

(b) Dividing any loan transaction into separate parts for the purpose and with the intent of evading the provisions of this section; or

(c) Any other such subterfuge.

The Attorney General, the commissioner of the Department of Financial Institutions, or any party to a high-cost home loan may enforce the provisions of this section. Any person seeking damages or penalties under the provisions of this section may recover damages under either this chapter or KRS Chapter 367, but not both.

(4) A lender of a high-cost home loan who, when acting in good faith, fails to comply with subsection (2) of this section, will not be deemed to have violated this section if the lender establishes that either:

(a) Within thirty (30) days of the loan closing the borrower is notified of the compliance failure, appropriate restitution is made, and whatever adjustments are necessary are made, at the choice of the borrower, to the loan to either:

1. Make the high-cost home loan satisfy the requirements of subsection (2) of this section; or

2. Change the terms of the loan in a manner beneficial to the borrower so that the loan will no longer be considered a high-cost home loan subject to the provisions of this section; or

(b) The compliance failure was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adopted to avoid such errors, and within sixty (60) days after the discovery of the compliance failure, the borrower is notified of the compliance failure, appropriate

restitution is made, and whatever adjustments are necessary are made to the loan to either, at the choice of the borrower, make the high-cost home loan satisfy the requirements of subsection (2) of this section or change the terms of the loan in a manner beneficial to the borrower so that the loan will no longer be considered a high-cost home loan subject to the provisions of this section. Examples of a bona fide error include clerical, calculation, computer malfunction and programming, and printing errors.

(c) For purposes of this subsection, "appropriate restitution" means the reimbursement by the lender of any points, fees, interest, or other charges made by the lender and received from the borrower necessary to put the borrower in the same position as he or she would have been had the loan, as adjusted in accordance with paragraphs (a) and (b) of this subsection, been originally made.

(5) For purposes of this section, any extension of credit shall be deemed to have been made in the Commonwealth of Kentucky, and therefore subject to the provisions of this section, if the lender offers or agrees in Kentucky to lend to a borrower, who is a resident of Kentucky, on real property located within the Commonwealth of Kentucky, or if such borrower accepts or makes the offer in Kentucky to borrow, regardless of the situs of the contract as specified therein. Any oral or written solicitation or communication to lend originating outside of Kentucky, but forwarded to and received in Kentucky by a borrower who is a resident of Kentucky, shall be deemed to be an offer or agreement to lend in Kentucky and, therefore, subject to this section. Any oral or written solicitation or communication to borrow originating within Kentucky, from a borrower who is a resident of Kentucky, but forwarded to and received by a lender outside of Kentucky, shall be deemed to be an acceptance or offer to borrow in Kentucky. Any oral or written offer, acceptance, solicitation, or communication to lend or borrow, made in Kentucky to, or received in Kentucky from, a borrower who is not a resident of Kentucky, shall be subject to the provisions of this section, applicable federal law, law of the situs of the contract, or law of the residence of the borrower, as the parties may elect. The provisions of this section shall be severable and if any phrase, clause, sentence, or provision is declared to be invalid, the validity of the remainder of this section shall not be affected thereby.





**BANKRUPTCY LAW UPDATE FOR BANK COUNSEL  
-2004-**

*Lea Pauley Goff  
Stoll, Keenon & Park, LLP  
Louisville, Kentucky*

Copyright 2004. Lea Pauley Goff. All Rights Reserved.

**SECTION E**



**BANKRUPTCY LAW UPDATE FOR BANK COUNSEL**  
**-2004-**

<b>I.</b>	<b>INTRODUCTION .....</b>	<b>E-1</b>
<b>II.</b>	<b>NEW BANKRUPTCY CASES .....</b>	<b>E-1</b>
<b>A.</b>	<b><u>Plan Confirmation / Consummation / Chapter 11 Issues</u> .....</b>	<b>E-1</b>
	Pacific Gas & Electric Co. v. California, ex rel. California Dept. of Toxic Substances Control, 350 F.3d 932 (9 <sup>th</sup> Cir. 2003) .....	E-1
	In re Kmart Corporation, 359 F.3d 866 (7 <sup>th</sup> Cir. 2004) .....	E-2
	In re ATD Corporation (ATD v. Advantage Packaging), 352 F.3d 1062 (6 <sup>th</sup> Cir. 2003) .....	E-3
<b>B.</b>	<b><u>Discharge And Dischargeability</u> .....</b>	<b>E-4</b>
	Monsanto Company v. Trantham (In re William Ferris Trantham), 2004 Fed. App. 0001P (6 <sup>th</sup> Cir. BAP, 2004) .....	E-4
	Kontrick v. Ryan, 124 S. Ct. 906 (2004) .....	E-4
	In re Maughan, 340 F.3d 337 (6 <sup>th</sup> Cir. 2003) .....	E-5
	In re Oyler, 300 B.R. 255 (BAP 6 <sup>th</sup> Cir. 2003) .....	E-6
	In re Herdean ( Demmitt & Owens Financial, Inc. v. Henderson), 2003 U.S. App. LEXIS 24849 (6 <sup>th</sup> Cir. 2003) (Unpublished) .....	E-6
<b>C.</b>	<b><u>Avoidance Actions</u> .....</b>	<b>E-7</b>
	In re Bever, 300 B.R. 262 (BAP 6 <sup>th</sup> Cir. 2003) .....	E-7
	In re The V Companies, 292 B.R. 290 (BAP 6 <sup>th</sup> Cir. 2003) .....	E-8
	In re Hurtado, 342 F.3d 528 (6 <sup>th</sup> Cir. 2003) .....	E-9

**SECTION E**

	In re Lowe (Spradlin v. Inez Deposit Bank) 2003 U.S. App. LEXIS 26698 (6 <sup>th</sup> Cir. 2003) (Unpublished) .....	E-9
	In re Johnson (Johnson v. Medical Center at Bowling Green), 59 Fed. Appx. 768 (6 <sup>th</sup> Cir. 2003) (Unpublished) .....	E-10
	In re Burns (Suhar v. Burns), 322 F.3d 421 (6 <sup>th</sup> Cir. 2003) .....	E-11
	In re Tri-City Turf Club, Inc. (Spradlin v. Jarvis), 323 F.3d 439 (6 <sup>th</sup> Cir. 2003) .....	E-11
	In re Skeans, 2003 Bankr. LEXIS 693 (Bankr. E.D. Ky. 2003) .....	E-12
<b>D.</b>	<b><u>Exemptions / Property of the Estate</u></b> .....	<b>E-12</b>
	In re Adams, 302 B.R. 535 (BAP 6 <sup>th</sup> Cir 2003) .....	E-12
<b>E.</b>	<b><u>Jurisdiction</u></b> .....	<b>E-13</b>
	In re Hood, 319 F.3d 755 (6 <sup>th</sup> Cir. 2003) .....	E-13
	In re G.A.D., Inc. (Eglington v. Loyer), 340 F.3d 331 (6 <sup>th</sup> Cir. 2003) .....	E-14
<b>F.</b>	<b><u>Attorneys</u></b> .....	<b>E-14</b>
	In re Airspect Air, Inc., 288 B.R. 464 (BAP 6 <sup>th</sup> Cir. 2003) .....	E-14
	In re Big Rivers Electric Corporation, 355 F.3d 415 (6 <sup>th</sup> Cir. 2004) .....	E-15
	Laimie v. United States Trustee, 124 S. Ct. 1023 (2004) .....	E-16
	In re Grieb Printing Company, Inc., 297 B.R. 82 (Bankr. W.D. Ky. 2003) .....	E-17
	Schilling v. Smith, 2003 U.S. Dist. LEXIS 16865 (W.D. Ky. 2003) .....	E-18
<b>G.</b>	<b><u>Miscellaneous</u></b> .....	<b>E-18</b>
	Citizens Bank v. Alafabco, Inc., 539 U.S. 52 (2003) .....	E-18
	Barnes v. Community Trust Bank, Ky. App. 121 S.W.3d 520 (2003) .....	E-19

## SECTION E

In re Robinson (Robinson v. Champagne Landmark), 330 F.3d 834 (6 <sup>th</sup> Cir. 2003) .....	E-20
In re Brookover, 352 F.3d 1083 (6 <sup>th</sup> Cir. 2003) .....	E-20
In re Fowler, 2004 Bankr. LEXIS 67 (E.D. Ky. 2004) .....	E-21
In re Behlke (Behlke v. Eisen) 358 F.3d 429 (6 <sup>th</sup> Cir. 2004) .....	E-21
<b>III. BANKRUPTCY LEGISLATION UPDATE .....</b>	<b>E-22</b>
<b>IV. SERVICEMEMBERS CIVIL RELIEF ACT .....</b>	<b>E-22</b>

## SECTION E



## **BANKRUPTCY LAW UPDATE FOR BANK COUNSEL**

**Lea Pauley Goff**

**Stoll, Keenon & Park, LLP<sup>1</sup>**  
**Louisville, Lexington, Frankfort and Henderson, Kentucky**

### **I. INTRODUCTION**

This outline reviews selected bankruptcy decisions during the past year, with a particular emphasis on decisions of interest to lenders in Kentucky and elsewhere in the Sixth Circuit. The decisions demonstrate continued development of the law on subjects including plan confirmation, discharge, professional conduct and others. Selected non-bankruptcy cases which are of interest to lenders are also included.

### **II. NEW BANKRUPTCY CASES**

#### **A. Plan Confirmation/Consummation/Chapter 11 Issues**

***Pacific Gas & Electric Co. v. California, ex rel. California Dept. of Toxic Substances Control*, 350 F.3d 932 (9<sup>th</sup> Cir. 2003)**

Here, the Ninth Circuit addressed the extent to which state regulatory schemes can be pre-empted by the bankruptcy court in the context of confirmation of a Chapter 11 plan. Pacific Gas & Electric Co. ("PG&E") proposed a plan of reorganization which would break up PG&E into four new corporations. The business of PG&E in its entirety had been regulated by the California Public Utility Commission ("CPUC") but, under its plan of reorganization, only one of the corporations would continue to be regulated by CPUC. The remaining three corporations would be under the exclusive regulatory authority of the Federal Energy Regulatory Commission. If the disaggregation of PG&E were not approved, it would remain under the regulatory authority of CPUC. Various government entities objected to the proposed plan, contending that the plan was prohibited by, and violated, several state regulatory statutes, a position which did not appear to be contested. Among other conflicts between the plan and state law, the debtor's disclosure statement identified the non-transferability of certain permits and licenses, stating that

[f]or these permits or licenses for which otherwise applicable nonbankruptcy law precludes transfer or gives state or local officials discretion to deny the transfer or reissuance, the [debtor] will rely on the protection of section 1123(a) to ensure

---

<sup>1</sup> Many thanks to our associates Lee A. Webb, Brett R. Hensley and Kathryn V. Eberle for their excellent research and drafting assistance, without which we would not have these materials.

that all of the reorganized companies obtain the permits and licenses they need to operate lawfully.

*Id.* at 936. The court was thus faced with the issue of a bankruptcy court's ability to confirm a plan, despite its prohibition in part by state regulatory statutes, pursuant to that portion of Section 1123(a)(5) which states that "notwithstanding any otherwise applicable nonbankruptcy law, a [reorganization] plan shall . . . provide adequate means for the plan's implementation."

The bankruptcy court rejected PG&E's broad pre-emption argument. The district court reversed, holding that Congress expressly intended to permit pre-emption of non-bankruptcy laws as necessary to implement a reorganization plan. The Ninth Circuit then reversed the district court, holding that the preemptive scope of a reorganization plan is set forth in § 1142(a), and non-bankruptcy law is pre-empted by a reorganization plan only to the extent that such law "relate[es] to financial condition."

**In re Kmart Corporation, 359 F. 3d 866 (7<sup>th</sup> Cir. 2004)**

Here, the Seventh Circuit affirmed the reversal of a bankruptcy court's order permitting the debtor to pay selected pre-petition debts on the basis that they were owed to "critical vendors." Kmart sought and obtained from the bankruptcy court an order permitting it to pay in full the pre-petition claims of "critical vendors." The order left the identity of the vendors to be paid in the discretion of Kmart. The order purported to rely on 11 U.S.C. § 105(a).

One creditor appealed the critical vendor order and, approximately 14 months later, the district court reversed the order. During that time, Kmart had paid over 2,300 vendors over \$300,000,000 in pre-petition claims. It did not pay the claims of approximately 2,000 other vendors apparently not deemed "critical" or the pre-petition claims of approximately 43,000 other unsecured creditors. The debtor appealed to the Seventh Circuit and several of the vendors who had received the payments intervened in the appeal. The appellants first argued that the matter was moot, because the money had already been paid. The Seventh Circuit held otherwise, noting that invalid preferential payments can always be recovered. The Court noted that the beneficiaries of some bankruptcy orders have specific protection from later reversals, but that concept is inapplicable to an order permitting the payment of pre-petition claims. The Court also noted that, even if detrimental reliance on the part of the recipients would permit them some relief on equitable grounds, there was no detrimental reliance here as these vendors got both their pre- and post-petition claims paid. (Had they extended new post-petition credit in reliance on the receipt of the payment for pre-petition claims, and then did not get paid post-petition, the result could be different).

One creditor also objected on the ground that it was not a party to the district court appeal. The Court noted that the only appellee to that was Kmart, but also stated that only 65 creditors got notice on the original critical vendor motion. Thus, the Court concluded that if lack of notice is an issue, it calls into question the original order to a greater extent than the subsequent appeals.



Turning to the merits of the critical vendor order, the Court noted that the power of the bankruptcy court under § 105 is limited -- the power "to implement rather than override." The Court held that the old "doctrine of necessity" is "just a fancy name for a power to depart from the Code." The Court concluded that the only Code section that had the potential to permit the preference of some vendors is § 363(b)(1) (the debtor-in-possession's ability to use property of the estate other than in the ordinary course of business). The Court did not decide whether this section permits the preferences at issue. Rather, it held that the order at issue would be deficient even if § 363 did permit the concept. The Court noted that any order permitting the payment of pre-petition claims would have to be based on proof that the disfavored creditors would be at least as well off under that scheme as otherwise (i.e., it would allow the debtor to operate longer and increase their chances of getting paid at the end), and evidence that "critical vendors" really would terminate services to the debtor without the payments. The Court noted that the testimony of the Kmart CEO on this point was insufficient as he cannot speak for the vendors themselves. The Court expressed the view that most vendors are unlikely to end the relationship if they can be assured of payment for the new trade, which the Court believed they could. In short, the Court found that there was simply no record to support the preferential payments under § 363, even if that section permits them.

**In re ATD Corporation (ATD v. Advantage Packaging), 352 F. 3d 1062 (6<sup>th</sup> Cir. 2003)**

The Sixth Circuit Court of Appeals affirmed an Ohio bankruptcy court's order allowing the claims of two creditors, despite their failure to file their claims before the bar date, because their claims had been scheduled by the debtor as undisputed, non-contingent and liquidated. The debtor appealed the order allowing the claims despite the creditors' failure to physically file proofs of claim before the bar date set by the court. The two creditors at issue were listed as holders of undisputed, non-contingent, liquidated claims in the debtor's schedules. Thus, the debtor conceded that the creditors were not required by either 11 U.S.C. § 1111(a) or Fed. Bankr. R. P. 3003 to execute and file proofs of claim. On the request of the debtor, the court later sent an order establishing a bar date for claims, but the creditors did not file a claim. The debtor then argued that, under § 105(a), the bankruptcy court had the power to, and in fact did by the bar date order, require that the creditors file these claims. The bankruptcy court disagreed, concluding that the bar date order did not serve to adequately notify creditors that they could no longer rely on 11 U.S.C. § 1111(a) and Bankruptcy Rule 3003 and allowed the claims. That court did not reach the issue of the bankruptcy court's ability to contravene § 1111(a). The district court affirmed, as did the Sixth Circuit. The Sixth Circuit noted that the bankruptcy court's powers under § 105 are limited to actions "not inconsistent" with other provisions of the Code. However, instead of deciding whether § 105 permits the court to require the claims, it simply held that the particular bar date order at issue did not give notice of an intent to override the other provisions.

## **B. Discharge and Dischargeability**

### **Monsanto Company v. Trantham (In re William Ferris Trantham), 2004 Fed. App. 0001P (6<sup>th</sup> Cir. BAP, 2004)**

The Sixth Circuit Bankruptcy Appellate Panel (“BAP”) held that a pre-petition patent infringement judgment against the debtor, which included treble damages, pre-judgment interest and attorney fees, was non-dischargeable, based on the preclusive effect of the underlying judgment.

Monsanto obtained its patent infringement judgment against Mr. Trantham in the U.S. District Court. That court concluded that the infringement was willful, but there was no actual intent to injure Monsanto -- Mr. Trantham simply did not want to pay license fees. Mr. Trantham promptly filed a Chapter 7 proceeding. Monsanto filed a complaint to determine the non-dischargeability of the debt under 11 U.S.C. § 523(a)(6) (debt arising as a result of willful and malicious injury by the debtor). Monsanto claimed that the collateral estoppel effect of the district court’s findings of willfulness, combined with the award of treble damages and attorney fees, showed that an intentional tort had occurred and that the judgment was non-dischargeable under § 523(a)(6). Mr. Trantham argued that the finding that there was no intent to injure Monsanto had the opposite preclusive effect -- it precluded the required element of maliciousness under § 523(a)(6). The bankruptcy court held that Monsanto did not meet its burden under that statute.

The BAP concluded that the issue of willfulness was actually raised, litigated and determined in the district court, as it was necessary to the outcome of the patent infringement action. The BAP also held that the same findings in the district court supported a finding of malicious injury. To find an injury “ ‘willful’ under section 523 (a)(6), [the court] must determine either that (i) the actor desired to cause the consequences of the act or (ii) the actor believed that the given consequences of his act were substantially certain to result from the act.” *In re: Markowitz*, 190 F. 3d 455 (6<sup>th</sup> Cir. 1999). The BAP found that, under the second prong, the debtor had committed willful injury because “where Trantham’s stated purpose in willfully infringing Monsanto’s patents was not to pay Monsanto for its technology, what else could Trantham believe would be the consequences of his act but that Monsanto would be deprived of money to which it was entitled?” He could gain only if Monsanto lost. The entire judgment for willful patent infringement was held non-dischargeable.

### **Kontrick v. Ryan, 124 S. Ct. 906 (2004)**

Here, the U.S. Supreme Court held that the time limits prescribed by Bankruptcy Rule 4004 concerning objections to discharge are not “jurisdictional.” It also held that a debtor forfeits its rights to rely on Rule 4004 if it does not raise the issue of the time limits before the bankruptcy court reaches the merits of the underlying action.

Dr. Andrew J. Kontrick filed a Chapter 7 bankruptcy petition on April 4, 1997. His former partner and a major creditor, Dr. Robert A. Ryan, opposed the discharge. After obtaining three time extensions, Ryan filed a complaint objecting to the discharge of any of Kontrick's debts, based on alleged fraudulent transfers. On May 6, 1998, with court approval, but without seeking or gaining an extension of time, Ryan filed an amended complaint and particularized for the first time the debtor's fraudulent transfers. He specifically alleged that the debtor fraudulently transferred money into a family account. The debtor answered the family account claim, but did not raise the timeliness of the claim in his answer. Ultimately, the bankruptcy court granted summary judgment to Ryan on the family account claim.

The debtor moved for reconsideration, claiming that the bankruptcy court lacked jurisdiction because the complaint was untimely. The bankruptcy court denied the motion for reconsideration and the district court upheld the bankruptcy court's decision. Both courts agreed that the debtor had waived the right to challenge the amended complaint as impermissibly late. The Seventh Circuit Court of Appeals also affirmed on similar grounds.

The Supreme Court granted certiorari to decide the issue of whether Rule 4004 is jurisdictional. The Court held that only Congress can determine a federal court's subject-matter jurisdiction. In this case Congress did so by labeling objections to discharge as core proceedings within the bankruptcy court's jurisdiction. Further, Congress did not build any time constraints into the statutory authorization. Rather, the time constraints are in the bankruptcy rules, which do not create or withdraw jurisdiction. The Court concluded that the time limitations in the rules are claim-processing deadlines that do not affect subject-matter jurisdiction. Accordingly, the Court held that the time limit under Rule 4004 is not "jurisdictional," without specifically addressing whether the time deadline may be altered for equitable or other reasons. However, the Court did find that a debtor may not raise the time limits contained in Rule 4004 after the court had decided the merits of the underlying action. Any objection to the timeliness of the complaint must have been raised in an answer or responsive pleading. The debtor failed to do so, therefore forfeiting his right to raise it later.

**In re Maughan, 340 F.3d 337 (6<sup>th</sup> Cir. 2003)**

Here, the Sixth Circuit Court of Appeals reversed the Bankruptcy Appellate Panel and held that the deadlines for filing complaints objecting to discharge are not jurisdictional, but are similar to statutes of limitations and are subject to the court's equitable powers.

The parties' relationship began when John Nardei purchased a coin business from Edwin Maughan. Maughan convinced Nardei that he could increase his return on his investment by trading the coins. Nardei gave Maughan his existing investment in gold coins plus additional payments to buy more coins. It became clear that Nardei's investment was not being used to purchase additional coins, but rather it was being used to buy jewelry for Maughan's retail jewelry store. Nardei sued Maughan and obtained a judgment. Nardei filed for bankruptcy protection.

During the bankruptcy, the court set a deadline of October 19, 1998, as the deadline for filing a complaint objecting to discharge. Nardei conducted a Rule 2004 exam of Maughan, but Maughan did not bring all of the documents as requested. Nardei missed the deadline for filing objections to discharge. On October 22, 1998, Nardei filed a motion for an extension of time to file objections to discharge. The extension was granted and Nardei filed a complaint objecting to discharge of the particular debt under § 523. Maughan appealed the bankruptcy court's decision granting the extension. The Bankruptcy Appellate Panel reversed, holding that the deadline for filing a complaint objecting to discharge was jurisdictional and not subject to the court's equitable powers. The Sixth Circuit then reversed. Relying on its decision in *In re Isaacman*, 26 F.3d 629 (6<sup>th</sup> Cir. 1994), the Court held that the deadline is not jurisdictional. Rather, the rule is a statute of limitation, or simply a deadline that is subject to the court's equitable powers.

**In re Oyler, 300 B.R. 255 (BAP 6<sup>th</sup> Cir. 2003)**

Here, the Bankruptcy Appellate Panel for the Sixth Circuit affirmed a bankruptcy court's decision discharging a debtor's student loan debt based on financial hardship.

The debtor, Michael Oyler, filed a Chapter 13 bankruptcy petition on September 9, 1999. Oyler filed an adversary proceeding seeking to discharge approximately \$38,000 in student loans pursuant to § 523(a)(8). The student loans were obtained by Oyler to fund his education at a theological seminary. Oyler was married and had three children. The family had an annual income of less than \$10,000. The bankruptcy court found that paying back the loans would create an undue financial hardship and discharged the debt. The bankruptcy court considered Oyler's current financial situation, the likelihood that the situation would continue, whether Oyler exercised good faith, the ability of Oyler and his wife to obtain outside employment, Oyler's lifestyle choice, and the use of the loans for the ministry.

In this appeal the loan servicer argued that the bankruptcy court erred by placing too much weight on the fact that the loans were used for an education in the ministry (i.e., an argument that the Debtor could seek another job). The court acknowledged that the Sixth Circuit has adopted a three-prong analysis in determining whether undue hardship exists: (1) that the debtor cannot maintain, based on current expenses and income, a minimal standard of living for himself and his dependents if forced to repay the loans; (2) that additional circumstances are present indicating that this situation is likely to persist for a significant portion of the repayment period; and (3) that the debtor has made a good faith effort to repay the loans. The court held that the bankruptcy court had properly considered all of the aforementioned factors in discharging the debt.

**In re Herdean (Demmitt & Owens Financial, Inc. v. Herdean), 2003 U.S. App. LEXIS 24849 (6<sup>th</sup> Cir. 2003) (Unpublished)**

The Sixth Circuit affirmed a ruling by a Michigan bankruptcy court that a factoring debt was dischargeable. The Sixth Circuit concluded that, while the bankruptcy court erred by

holding that the creditor did not rely on the debtor's misrepresentations, the creditor's damages did not result from that reliance.

The creditor was engaged in the practice of factoring and entered into a contract permitting it to purchase Herdean's company's accounts receivable. As part of the agreement, Herdean represented that he was aware of no deductions or setoffs that could reduce the amount of these accounts receivable. When it became apparent that there were deductions and setoffs that could be taken against these accounts receivable, the creditor and Herdean reached a new "buy back" agreement that would allow the creditor to keep a larger portion of future receipts on the Herdean accounts. Herdean also agreed to attempt to lower the deductions. However, the deficiencies continued and the relationship ended.

In Herdean's later bankruptcy, the creditor sought a determination that the debt was not dischargeable under § 523(a)(2)(A) as fraudulently obtained. The bankruptcy court found that the creditor had not relied on the original representations and the debt was dischargeable. The district court affirmed, as did the Sixth Circuit, but on different grounds. The Sixth Circuit found that the creditor had relied on the debtor's original statements that no deductions existed. However, the court found that the damages that the creditor sought arose after it was on notice of debtor's fraud, as the damages were a result of its second contract to "buy back" the accounts receivable. The creditor was deemed to have assumed the risk that the debtor might not be able to prevent future deductions. The court concluded that no damages had resulted from the debtor's misrepresentations. Therefore, the debt was held dischargeable.

### **C. Avoidance Actions**

#### **In re Bever, 300 B.R. 262 (BAP 6<sup>th</sup> Cir. 2003)**

Here, the BAP for the Sixth Circuit affirmed an Ohio bankruptcy court's denial of a creditor's motion to vacate the Chapter 7 trustee's sale of a residence back to the debtor.

The debtors filed their Chapter 7 case on February 7, 2001. On March 30, 2001, notice was sent at the behest of the trustee of the need to file proofs of claim by July 2, 2001. The schedules listed an \$88,000 mortgage held by Old Kent Mortgage Company ("Old Kent") on their residence, which they valued at \$100,000. During the summer of 2001, Bank One apparently acquired the mortgage from Old Kent's successor. A second institution was listed in the schedules as holding a second mortgage claim in the amount of approximately \$20,000.

On September 18, 2001, the trustee filed an adversary proceeding against both mortgagees seeking to avoid the asserted mortgages on the basis that only one witness was present when the mortgages were executed. Summonses were served via certified mail. No one responded. On January 10, 2002, the court entered default judgment avoiding the mortgages. The trustee, after sending notice by regular U.S. mail on April 5, 2002, sold the property back to the debtors for \$15,000, a sum that paid all allowed claims in full.

On September 9, 2002, fourteen months after the deadline for filing proofs of claim, Bank One filed a proof of claim for \$98,296.74. Bank One then filed a motion to vacate the sale. Bank One's motion alleged that (1) the sale was not equitable; (2) service of the sale notice was insufficient; and (3) the sale did not comply with due process. The bankruptcy court construed the motion as one under FRCP 60(b) (applicable through Federal Rule of Bankruptcy Procedure 9024). The bankruptcy court held there was no support for a finding of excusable neglect under Rule 60(b)(1) notwithstanding the mortgage assignment and that service of process had been sufficient.

The BAP affirmed the bankruptcy court's decision. The court held that there was no inequity in selling the residence for \$15,000, because any windfall to the debtors was caused by Bank One's failure to participate in the bankruptcy process and, since Bank One filed no timely claim, the sale price was adequate to pay all allowed claims. Further, the Court held that service of the sale notice was sufficient and did not need to meet the requirements of a sale free and clear of liens. It concluded that, following the default judgment, Bank One did not have a lien on the property. The BAP held that Bank One also lacked a property right sufficient to invoke the protection of the Fifth Amendment or other rights associated with mortgagee status.

**In re The V Companies, 292 B.R. 290 (BAP 6<sup>th</sup> Cir. 2003)**

Here, the BAP for the Sixth Circuit upheld a bankruptcy court ruling granting derivative standing to a creditor to pursue avoidance actions.

The jointly administered bankruptcy cases involved in this adversary proceeding were originally filed under Chapter 11 on January 7, 2000. The U.S. Trustee eventually moved for the case to be converted to a Chapter 7. While that motion was pending, the Jefferson County Board of Commissioners ("Board"), a creditor, sought leave to pursue certain avoidance actions against defendants, including several insiders of the debtor companies. Leave was granted and the action was filed. The case was later converted, and the Chapter 7 Trustee moved to be added as a co-plaintiff.

The defendants filed a motion to dismiss the AP, arguing that the Board lacked standing to pursue avoidance actions. The bankruptcy court denied the motion to dismiss but substituted the trustee as the plaintiff. The defendants sought review.

The defendants argued that the U.S. Supreme Court's ruling in *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 147 L. Ed. 2d 1 (2000) prevented non-trustees from pursuing avoidance actions. In *Hartford*, the Supreme Court held that an administrative claimant does not have independent standing to bring a claim under 11 U.S.C. § 506(c) and that entities other than the trustee are not entitled to use § 506 (recovery from collateral of the reasonable and necessary costs of preserving or disposing of it). The court held that *Hartford* was not controlling because the Supreme Court specifically refused to extend its holding to the issue of derivative standing. The court rejected the defendants' claim that *Hartford* overruled *In re Gibson Group*, 66 F.3d 1436 (6<sup>th</sup> Cir. 1995), in which the Sixth Circuit held that a creditor could

be granted leave to pursue avoidance actions under § 547 and § 548 if certain conditions were met. The BAP held that *Gibson* remained good law and controlled this case. Under *Gibson*, a bankruptcy court may permit a single creditor in a Chapter 11 case to initiate an action to avoid a preferential or fraudulent transfer instead of the debtor-in-possession if the creditor (1) has alleged a colorable claim that would benefit the estate, if successful, based on a cost-benefit analysis performed by the bankruptcy court; (2) has made a demand on the debtor-in-possession to file the avoidance action; (3) the demand has been refused; and (4) the refusal is unjustified in light of the statutory obligations and fiduciary duties of the debtor-in-possession in a Chapter 11 reorganization.

Based on *Gibson*, and a discussion of the reality that a trustee and debtor-in-possession have the same powers, but frequently not the same interest to pursue avoidance actions, the BAP concluded that the bankruptcy court properly granted the Board derivative standing to file the adversary complaint against the defendants and affirmed the denial of the motion to dismiss.

**In re Hurtado, 342 F.3d 528 (6<sup>th</sup> Cir. 2003)**

Here, the Sixth Circuit addressed whether the debtor's mother was an "initial transferee" from whom the trustee could recover a fraudulent conveyance under 11 U.S.C. § 550. During a time in which they had significant debts, Denise and John Rey Hurtado received two substantial blocks of income. First, they received \$83,247.93 in 1992 when they sold their house, and then received \$130,795.00 in 1995 when they settled a lawsuit. They transferred the money to Barbara Hurtado (the mother of John Rey). She kept the funds and spent them at the direction of the younger Hurtados. The money was used for their living expenses and the payment of certain creditors. She kept the money separate from hers and never spent it on herself.

The debtors filed a Chapter 7 proceeding on September 9, 1998 and were discharged on December 15, 1998. The trustee filed a complaint to avoid the transfer, recover the funds and to revoke the discharge (the debtors were eventually dismissed). The bankruptcy court granted Barbara Hurtado's motion for summary judgment, finding that she did not have sufficient control over the funds, was a mere conduit, and therefore could not be held liable. The district court reversed, finding that Ms. Hurtado was liable as an initial transferee under 11 U.S.C. § 550. The Sixth Circuit affirmed. The court noted that initial transferees are strictly liable for fraudulent transfers they receive. However, an initial transferee must have dominion and control over the funds. The Sixth Circuit found that Barbara Hurtado satisfied this test. She was given legal title to the funds in order to insulate the debtors from creditors. Through this mechanism, the funds could no longer be considered assets of the debtor. She could have done what she liked with the funds; the fact that she did not was of no import.

**In re Lowe (Spradlin v. Inez, Deposit Bank) 2003 U.S. App. LEXIS 26698 (6<sup>th</sup> Cir. 2003) (Unpublished)**

Here, the Sixth Circuit concluded that a residential mortgage made within 90 days of the debtor filing for bankruptcy did not constitute a voidable preference under 11 U.S.C. § 547. The

debtor refinanced and used the loan proceeds to purchase his ex-wife's interest in the residence and to repay the balance owed to the mortgagee under a previous mortgage of the property. The Sixth Circuit looked at whether the transfers to the ex-wife and to the prior mortgagee were on account of antecedent debts and whether they increased the transferee's share of the bankruptcy estate.

The borrower executed a new mortgage on June 30, 2000 and his right of rescission expired July 5, 2000. The lender issued a check to the former wife on July 6, recorded its new mortgage July 13, and paid off the original mortgage on July 14, 2000. The borrower then promptly filed a Chapter 7 proceeding. The trustee sought to avoid the mortgage on the ground that it secured an antecedent debt (i.e., the "transfer" occurred with the June 30, 2000 execution of the mortgage but the mortgage was not perfected until July 13, 2000, outside the ten-day "safe harbor" provision of § 547(e)(2)). The bankruptcy court granted summary judgment to the trustee, and the district court reversed, on the ground that it was an enabling (i.e., purchase money) loan.

The Sixth Circuit affirmed. It found that the transfer (i.e., the mortgage) was "made" at the point at which it took effect, which was the date at which it became enforceable against the debtor -- i.e., after the rescission right expired. Since the transfer was perfected in fewer than ten days from that date, the transfer was deemed made as of that date. The court found that the debt with relation to purchasing the ex-wife's interest was incurred on the date that the bank disbursed the funds to her as the debtor had no duty to repay the loan until the funds were disbursed. Thus, this debt was not antecedent.

With respect to repayment of the existing mortgage, the court concluded that the new loan was simply substituted for the old one and, as such, was an antecedent debt. However, the replacement mortgage did nothing to improve the bank's position because the previous loan was secured by a mortgage on the residence. Thus, the court concluded that the mortgage transfer still was not voidable under section 547(b).

**In re Johnson (Johnson v. Medical Center at Bowling Green), 59 Fed. Appx. 768 (6<sup>th</sup> Cir. 2003) (Unpublished)**

In this case, the court found that a wage garnishment did not constitute an avoidable preference under Kentucky law because it was involuntary in nature. The Medical Center received a default judgment against Mr. Johnson. An order of wage garnishment was issued on the judgment, but Mr. Johnson later filed for bankruptcy protection. The garnishment occurred within 180 days prior to the voluntary petition but outside the 90-day period prior to the petition. The debtor challenged this garnishment as an impermissible preference under KRS § 378.060 and 378.070. The bankruptcy court ruled for the creditor, the district court affirmed and the Sixth Circuit did likewise. His insolvency during all relevant times was apparently not disputed. Because Johnson was already insolvent at the time garnishment was instituted, he argued that a presumption existed that he intended to create a wrongful preference. However, the court found



that this presumption was sufficiently rebutted by the involuntary nature of the garnishment -- i.e., he did not intend that the transfer take place.

**In re Burns (Suhar v. Burns) 322 F. 3d 421 (6<sup>th</sup> Cir. 2003)**

Here, the Court ruled that a creditor whose mortgage lien had been avoided under 11 U.S.C. § 544 could not obtain a lien under 11 U.S.C. § 550, which provides certain protections to entities from whom a trustee recovers property for the estate. The trustee avoided IMC's mortgage on residential property on the ground that the execution of the mortgage was not witnessed by two people, as required by Ohio law. IMC then sought a ruling that it was entitled to a lien under various subsections of 11 U.S.C. § 550, which provide for certain good faith transferors to have liens for the cost of improvements on property which the trustee recovers from them -- on the theory that IMC or the entity which assigned the mortgage to it had paid off a prior encumbrance. The bankruptcy court held that § 550 was not applicable at all because the trustee had not recovered anything from the mortgagee. The Sixth Circuit BAP affirmed.

The Sixth Circuit affirmed. The court stated, "avoidance and recovery are distinct concepts and processes." The court found that "[t]he fact that avoidance and recovery are distinct does not mean that avoidance cannot trigger recovery, but it does suggest that avoidance need not always trigger recovery." It held that the remedy of recovery is only necessary where avoidance is inadequate, unlike the situation in this case. The court concluded "that the language of section 550, stating that the 'trustee may recover' property following avoidance 11 U.S.C. § 550 (emphasis added), is permissive rather than mandatory (the trustee 'must' recover) or descriptive (the trustee 'thereby' recovers)." In the instant case "IMC's interest was preserved by section 551 and returned to the estate under section 541. Recovery was not necessary because the code itself provided for the interest's return to the estate." Where a creditor has a possessory interest in the debtor's property, generally the trustee will have to pursue recovery since avoidance would not bring the property into the estate's possession. However, when a creditor, such as IMC, has a non-possessory interest, the trustee will not have to seek recovery generally.

The decision also discusses appeal time limitations issues in the context of amended notices of appeal.

**In re Tri-City Turf Club, Inc. (Spradlin v. Jarvis), 323 F. 3d 439 (6<sup>th</sup> Cir. 2003)**

The Sixth Circuit Court of Appeals affirmed the district court's holding that a material supplier's recovery of fabricated steel that it had provided to debtor was not a preferential transfer. The court found that the debtor was a third-party beneficiary of the contract between the material supplier and the general contractor working for the debtor. However, as a third-party beneficiary, the debtor could only assert the rights available to its general contractor under the contract. The contract between the general contractor and the supplier specified that the general contractor was to make payment for the steel on delivery. However, following delivery, the general contractor advised the supplier that payment would not be made and that the supplier should reclaim. The court held the trustee failed to show that the general contractor, and thus the

debtor, had any interest in the steel sufficient to establish that the steel would have been part of the estate. Since the steel had never been part of the estate, its reclamation could not constitute a preferential transfer.

**In re Skeans, 2003 Bankr. LEXIS 693 (Bankr. E.D. Ky. 2003)**

In this Chapter 7 proceeding, the court concluded that all-terrain vehicles (“ATVs”) are not motor vehicles, for purposes of a statutory requirement that a secured creditor’s lien is required to appear on the title of a motor vehicle.

The debtors gave the bank a security interest in two ATVs. The bank’s liens were not noted on either certificate of title, but the bank filed a UCC financing statement covering both ATVs. The debtors filed their Chapter 7 petition on December 16, 2002. When the trustee attempted to sell the ATVs, the bank objected, contending that it had a properly perfected security interest in both ATVs, notwithstanding its failure to note the liens on the ATVs certificates of title. The bank argued that the ATVs were excepted from the titling and lien notation requirements set forth in the Kentucky Revised Statutes by virtue of being considered “off-road vehicles.”

The court considered the various titling and lien notation statutes (KRS 186.010 et seq.) and ultimately decided that ATVs did not fit the definition of vehicle as set forth in KRS 186.010(8)(a). Because the ATVs were not vehicles the requirements of the titling statutes did not apply, and the failure to note the liens on the certificates of title was not dispositive. The court noted that the titling statutes were intended to regulate vehicles which travel over the highways of the Commonwealth, and ATVs were not such vehicles. The court held that the trustee could not sell the ATVs unless the sale price exceeded the amount of indebtedness secured by the perfected lien in favor of the bank.

**D. Exemptions/Property of the Estate**

**In re Adams, 302 B.R. 535 (BAP 6<sup>th</sup> Cir. 2003)**

Here, the Bankruptcy Appellate Panel for the Sixth Circuit held that the debtors’ retirement accounts were not necessarily excluded from their Ohio bankruptcy estate.

The debtors, Mr. And Mrs. Raymond Adams, each had an interest in a separate retirement account. Both plans qualified as 26 U.S.C. § 403(b) tax-sheltered annuity pension plans. Both had transfer restrictions that generally prevented the debtors from reaching the funds until age 59½. The bankruptcy court held that both of the plans were excluded from the property of the estate by § 541(c)(2) which provides that restrictions on the transfer of a beneficial interest of the debtor in a trust which are enforceable under applicable non-bankruptcy law are enforceable in bankruptcy.

The BAP reversed the bankruptcy court and remanded the action for further proceedings. The BAP noted that the bankruptcy court failed to first determine whether a trust existed. The debtors argued that any ERISA-qualified plan must be such a trust. The BAP rejected this argument and held that there is nothing in either ERISA or the IRS Code that mandates such a conclusion. The court noted that, while ERISA's trust requirements usually satisfy those of § 541(c)(2), ERISA exempts § 403(b) annuity plans from the ERISA trust requirements. Further, the court noted that there is no statutory support in the Bankruptcy Code for the concept that, in determining whether a trust was created, employee benefit plans are subject to less stringent standards than other assets. The court found that it was not self-evident that these plans constituted a trust. The court stated that there was no mention of a trust, there was no appointment of a trustee, there were no formal grants in trust, and there was no direct manifestation of any intent to create a trust in anyone.

Because the bankruptcy court decided that § 541(c)(2) issue in the context of overruling the trustee's objection to the debtors' claims that the pension funds were exempt, having found that the debtors failed to prove the funds were not property of the estate under § 541(c)(2), the BAP remanded the matter to the bankruptcy court to consider remaining issues regarding exemptions for the plans.

#### **E. Jurisdiction**

##### **In re Hood, 319 F. 3d 755 (6<sup>th</sup> Cir. 2003)**

In this case, the Sixth Circuit dealt with the abrogation of state sovereign immunity in the context of the Bankruptcy Code. The court concluded that the Bankruptcy Clause granted Congress the power to abrogate state sovereign immunity, which power Congress clearly exercised in 11 U.S.C. § 106(a).

The debtor filed a Chapter 7 bankruptcy petition, at which time she owed money on student loans guaranteed by the Tennessee Student Assistance Corporation (TSAC). TSAC took no action in the bankruptcy case, and Hood was granted a discharge. She later filed an adversary proceeding requesting discharge of her educational loans on the grounds of undue hardship pursuant to 11 U.S.C. § 523(a)(8). TSAC moved to dismiss, asserting that the adversary proceeding was barred by sovereign immunity. The bankruptcy court denied the motion to dismiss, holding that 11 U.S.C. § 106 properly abrogated TSAC's sovereign immunity. The BAP affirmed, and TSAC appealed. The Sixth Circuit affirmed in a lengthy analysis of the Bankruptcy Clause of Article I, Section 8 of the Constitution.

The court began its analysis by citing the conclusion of *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 134 L. Ed. 2d 252, 116 S. Ct. 1114 (1996), that the Indian Commerce Clause did not grant Congress the power to abrogate state sovereign immunity. "[T]he Eleventh Amendment restricts the judicial power under Article III, and Article I cannot be used to circumvent the constitutional imitations placed upon federal jurisdiction." The Sixth Circuit noted that five other circuits (3<sup>rd</sup>, 4<sup>th</sup>, 5<sup>th</sup>, 7<sup>th</sup> and 9<sup>th</sup>) have concluded that, under *Seminole Tribe*, Congress could not abrogate state sovereign immunity by relying on its Bankruptcy Clause

powers. The Sixth Circuit reached the opposite conclusion, based on an analysis of the grant by Article I, Section 8 of the Constitution of the power to establish “uniform” bankruptcy laws and what the court deemed to be the intent of the framers that a constitutional uniformity requirement gives the federal government exclusive jurisdiction of an issue and authorizes abrogation of state sovereign immunity. Accordingly, TSAC was held not to be immune from suit under 11 U.S.C. § 523(a)(8).

The U.S. Supreme Court granted certiorari and heard oral argument in March, 2004.

**In re G.A.D., Inc. (Eglinton v. Loyer) 340 F. 3d 331 (6<sup>th</sup> Cir. 2003)**

The Sixth Circuit Court of Appeals held that the district court had not abused its discretion by denying a pro se litigant’s motion to reconsider an order based upon FRCP 60(b)(1) almost a year after the order was entered. Ms. Eglinton failed to meet the deadlines for a response to a landlord’s motion to dismiss her complaint against it, and a response to a motion to remove her complaint to a related bankruptcy proceeding. The bankruptcy court dismissed her claims. She then failed to file notice of appeal of the bankruptcy court’s decision, but filed a Rule 60(b) motion nearly a year later. The plaintiff claimed that the bankruptcy court lacked jurisdiction to enter the order against her as her claim was not a core proceeding. However, the court found that resolving this dispute would require examining the purported lease assignment at issue and deciding if the transfer was valid as well as analyzing section 365 of the Bankruptcy Code relating to executory contracts and unexpired leases. The court noted that, even if it had decided the dispute was not a core proceeding, the untimeliness of her motion would defeat the plaintiff’s claims.

**F. Attorneys**

**In re Airspect Air, Inc., 288 B.R. 464 (BAP 6<sup>th</sup> Cir. 2003)**

In this case, the Bankruptcy Appellate Panel for the Sixth Circuit reversed an Ohio bankruptcy court’s reduction of the attorney fee due debtor’s special counsel. The issue was whether the prior approval of counsel’s contingency fee agreement in an action against the debtor’s landlord was improvident under § 328.

Prior to 1993, Airspect Air, Inc. (“Airspect”) entered into a long-term lease with the City of Akron to operate a “fixed base operation” at the Akron-Fulton International Airport. Disputes quickly arose regarding the terms of the lease and Airspect began withholding payments from the City. In January 1993, Airspect became involved in litigation with the City over the terms of the lease. In March, 1996, the debtor filed a Chapter 11 petition and the pending state court lease dispute became an adversary proceeding in the bankruptcy court. The debtor’s counsel in that matter was approved as special counsel pursuant to a contingent fee arrangement under which the fees started at 33%, if settled prior to trial. The lease at issue was subsequently deemed rejected by operation of law, although bankruptcy litigation continued concerning the City’s right to stay relief or not, given the value of leasehold improvements.

Several years later, the litigation settled and the City paid Airspect \$575,000 (based largely on the value of the improvements) in exchange for Airspect vacating the premises. The attorneys representing Airspect in the action against the states were to receive \$189,750, or one-third of the settlement. The debtor's sole shareholder objected. The bankruptcy court initially held that the contingency agreement was invalid because the contingency had not been met and awarded \$37,050 as a "reasonable" fee under 11 U.S.C. § 330. The BAP reversed and remanded the action to the bankruptcy court with instructions to review the fee application under § 328 and award the contingent fee unless the initial approval was "improvident" in light of subsequent events. On remand the bankruptcy court found that its approval of the fee agreement was improvident, based on the rejection of the lease as an intervening factor. The BAP reversed again, finding that the bankruptcy court's decision was clearly erroneous. In order to render a decision improvident, the intervening factor must be one that would have affected the court's decision in the first place. In this case the only intervening factor cited by the court was the rejection of the lease by Airspect. That event was irrelevant to what the attorneys were doing in pursuit of the lawsuit against the City. Airspect would have been entitled to damages whether the lease was terminated or not. The decision contains a fairly detailed comparison of § 328 and § 330.

**In re Big Rivers Electric Corporation, 355 F.3d 415 (6<sup>th</sup> Cir. 2004)**

In this case the Sixth Circuit addressed the duties of disinterest and disclosure of an examiner appointed to facilitate the reorganization of a Chapter 11 debtor. The court upheld the lower court's decision requiring the examiner to disgorge nearly \$1 million in fees paid to him based on his failure to remain a disinterested party.

On September 26, 1996, Big Rivers Electric Corporation ("Big Rivers") filed the largest Chapter 11 bankruptcy ever filed in Kentucky. The bankruptcy court decided an examiner should be appointed and ordered the U.S. Trustee to select one. The order instructed the Examiner to attempt to negotiate a global settlement. It did not specify the compensation. Big Rivers had debt totaling \$1.2 billion, of which approximately \$1.1 billion was owed to the Rural Utilities Service of the United States Department of Agriculture ("RUS"). Chase, Bank of New York and Mapco (the "Banks") also had large unsecured claims.

In late 1996, the Examiner held meetings with the major secured and unsecured creditors and discussed with them an arrangement under which they would pay him a percentage fee based on the success he brought to the estate in the form of new value. The bankruptcy court later entered an order providing for the Examiner's fees to be paid at an hourly rate.

Following additional communications between the Banks and the Examiner regarding his fees, Big Rivers filed its proposed plan of reorganization. The Examiner then sought and received the bankruptcy judge's approval, ex parte, to begin negotiating a percentage based fee with the Banks, which he did. There were significant communications about the fee but the discussions were not disclosed at that time.

Later, he filed a request for payment of administrative expenses which explained that he might seek \$4.41 million in compensation based on new value he had brought into the estate. While this disclosed his plan to seek a percentage-based fee, it did not disclose any agreement with the Banks to have the fee paid directly by them. The bankruptcy court subsequently confirmed a plan that included \$147 million in new value for the creditors, in part because the Examiner supported an auction of the assets, rather than the pre-petition deal the parties had already struck.

The RUS and the U.S. Trustee later requested discovery into the Examiner's fee arrangements. The extent of the negotiations with the individual creditors regarding compensation, and the extent to which there actually was an agreement, were disputed. After the Examiner filed his final fee application seeking \$4.41 million in compensation, the U.S. Trustee filed a motion to disgorge all of the Examiner's fees. The bankruptcy judge recused himself. Another judge awarded the Examiner over \$2.6 million, which covered his hourly compensation plus an enhancement of four times that amount – to be paid by Big Rivers. The district court affirmed the base compensation but reversed the enhancement. The district court remanded the disgorgement issue to be considered by the bankruptcy court. The case was transferred to the district court. After additional recusals, the case was assigned to Judge Avern Cohn of Michigan. Judge Cohn granted the motion for disgorgement and ordered the Examiner to disgorge all fees already paid to him, over \$900,000.

The Sixth Circuit affirmed, with an extensive discussion of the concept of “disinterestedness.” First, it held that the Examiner had violated his duty to remain disinterested. It held that a single agreement with a creditor that linked the Examiner's compensation to the amount recovered by the creditor qualifies as an interest because of the risk that the Examiner will favor one creditor over another. It noted that whether an Examiner actually does anything improper is irrelevant. The fact that he might disqualifies him. Second, the Court held that the Examiner violated his disclosure obligations. Each time he filed interim fee applications he was required to disclose all payments made or promised to him. He failed to disclose his agreements or potential agreements with the creditors. Third, the court concluded that he violated his duty of loyalty by his entering into an oral agreement with one of the Banks and by not fully disclosing his actions to the Court and to the parties during his negotiations with the parties.

Having concluded that the Examiner violated his duties, the Court held that the bankruptcy court did not abuse its discretion in ordering him to disgorge all fees paid to him. The Court acknowledged that total disgorgement was a drastic sanction, but agreed that it was appropriate, as “the price of disloyalty.”

**Laimie v. United States Trustee, 124 S. Ct. 1023 (2004)**

Here, the United States Supreme Court affirmed the decisions of lower courts refusing to award fees under § 330(a) of the Bankruptcy Code to an attorney who had not been formally engaged in a Chapter 7 proceeding.

Equipment Services, Inc. ("ESI") retained an attorney to prepare, file, and prosecute a Chapter 11 bankruptcy proceeding on its behalf. He did so, all the while representing ESI with the approval of the court under § 327 of the Bankruptcy Code. Three months into the Chapter 11 proceeding, the United States Trustee filed a motion to convert the case to a Chapter 7 liquidation proceeding. The court granted the motion to convert and appointed a Chapter 7 trustee. This terminated ESI's status as a debtor-in-possession and the attorney's service under § 327. The attorney continued to provide services to ESI without the authorization of the trustee. The attorney filed a fee application seeking compensation for the time he spent on ESI's behalf after the conversion. The government objected arguing that the current version of § 330(a)(1) makes no provision for the estate to compensate an attorney not authorized under § 327. The court agreed and denied the attorney's fee application. He unsuccessfully sought reversal of the decision at the district and court of appeals levels. Both courts concluded that the plain language of § 330(a)(1) controlled and did not allow the attorney to recover. He then appealed to this Court.

On appeal the attorney argued that the Court should look to the legislative history to determine Congress' intent because the existing statutory language is ambiguous in light of its predecessor. Before the 1994 amendment, § 330(a)(1) permitted an award to a "professional person employed under section 327 . . . or to the debtor's attorney." In contrast, the amendment deleted the phrase "or to the debtor's attorney." He argued that the statutory language is facially irreconcilable with other parts of the statute, thus making it ambiguous. Specifically, he argued that § 330(a)(1)(A)'s reference to "attorney" is facially irreconcilable with section's first part because, before the amendment, the lists were parallel. The Court rejected this argument. The Court held that while the present statute is awkward and ungrammatical, that does not make it ambiguous on the point at issue on this appeal. Subsection (A) allows compensation for services rendered by four types of persons but, unless an applicant is in one the classes named in the first part, the type of service is irrelevant. In addition, the Court held that the plain meaning of § 330(a)(1) does not lead to absurd results. Compensation remains available to attorneys through various other methods.

**In re Grieb Printing Company, Inc., 297 B.R. 82 (Bankr. W.D. Ky. 2003)**

Here, the court determined that an attorney had violated both ethical and statutory duties as trustee by reason of his representation of an adverse party in a separate bankruptcy proceeding. The court ordered that the attorney disgorge a portion of the compensation paid to him and that he withdraw as trustee as well as counsel for both parties.

The debtor in this case filed its Chapter 7 petition on February 17, 1998. J. Baxter Schilling was appointed Trustee, and then employed himself as the Trustee's attorney. In his role as trustee, he filed a proof of claim on behalf of the Debtor company in the separate bankruptcy of the Louisville Manufacturing Company, Inc. ("LMC Bankruptcy") in the amount of \$2,369.

At approximately the same time, a principal of LMC contacted Mr. Schilling to represent him with respect to a Rule 2004 Examination in the LMC bankruptcy. The attorney failed to recall the Grieb estate, accepted representation of the LMC principal and ultimately was paid approximately \$11,000 by that client.

The LMC Bankruptcy Trustee and the U.S. Trustee challenged the representation. The court determined that the attorney had a conflict of interest, however unintentional. The court admonished the attorney for failing to have in place a formal method of reviewing current representations to determine whether any new representation would present a conflict of interest. The court noted that it had discretion in fashioning an appropriate sanction for the attorney's conduct, and ordered the attorney to forfeit fees equal to the amount paid to him by the principal in the LMC Bankruptcy. Finally, the court ordered the attorney to withdraw as trustee, as counsel for the trustee, and as counsel for LMC's principal.

**Schilling v. Smith, 2003 U.S. Dist. LEXIS 16865 (W.D. Ky. 2003)**

The United States District Court affirmed the bankruptcy court's decision ordering the trustee to disgorge all compensation paid to him.

Here, the trustee in a Chapter 7 bankruptcy case hired himself as counsel for the purpose of filing adversary proceedings. The trustee filed a complaint against the debtor objecting to discharge and filed a complaint against the debtor's brother attempting to set aside a fraudulent conveyance. The trustee then sought and was awarded interim attorney fees, in a reduced amount. The trustee and the debtor subsequently entered into a settlement agreement that resolved both adversary proceedings for payment to the estate of \$50,000. One provision of the settlement agreement required the debtor to support the trustee's request that the court reconsider its previous order disallowing a portion of his fees. The trustee filed a second request for attorney fees and, almost a year after the bar date, filed seven claims on behalf of unsecured creditors. The bankruptcy court concluded that the trustee overreached and acted in his own self-interest while preparing and tendering the settlement agreement. The court determined that he used the settlement agreement to silence objections to his actions, to garner support for his fees, to eliminate the debtor as a potential beneficiary of the estate, and to attempt to recover previously disallowed fees. Further, the bankruptcy court determined the trustee filed the late claims for the purpose of distributing assets to non-filing claimants in breach of his duty to the estate and the debtor as a party in interest. The bankruptcy court ordered that the trustee's fees be reduced by 50% and later ordered the fees be disgorged in their entirety.

This court, on appeal, affirmed the decision and held that the trustee was not a disinterested person as required by the bankruptcy code and affirmed the bankruptcy court's order to disgorge fees.

**G. Miscellaneous**

**Citizens Bank v. Alafabco, Inc., 539 U.S. 52 (2003)**



In this case the United Supreme Court held that certain debt-restructuring agreements sufficiently involved interstate commerce to permit the invocation of the Federal Arbitration Act (FAA).

In 1986 Citizens Bank ("Citizens") entered into a quasi-contractual relationship with Alafabco, Inc. ("Alafabco") in which Citizens agreed to provide operating capital necessary for Alafabco to secure and complete construction contracts. In 1998, Alafabco became delinquent in repaying its existing obligations to Citizens. On two separate occasions the parties attempted to resolve outstanding debts by executing renewal notes. Both renewal notes contained functionally identical arbitration clauses. Following the second restructuring agreement, Alafabco brought suit in an Alabama state circuit court alleging breach of contract and various lender liability-type torts. The bank moved to compel arbitration, which the circuit court ordered.

The Alabama Supreme Court reversed, holding that the debt lacked sufficient involvement with interstate commerce and thus the FAA did not apply. Specifically, that court held that there was no showing that any part of the debt was actually attributable to interstate transactions; that the funds comprising that debt originated out of state; or that the debt was inseparable from any out-of-state projects.

The U.S. Supreme Court reversed. It held that the Alabama court misapplied the FAA's reference to contracts evidencing transactions "involving commerce," which is broader than "in commerce." The Supreme Court held that "involving commerce" was the functional equivalent of "affecting commerce" and was to be interpreted so as to signal the broadest permissible exercise of Congress' commerce clause power. The Court held that the restructuring agreements were well within Congress' commerce clause based on three reasons: 1) Alafabco was engaged in business all throughout the southeastern United States using substantial loans from Citizens; 2) the debt was secured by all of Alafabco's business assets, including its inventory of goods assembled from out-of-state parts and raw materials; and 3) the general practice of commercial lending greatly affects interstate commerce.

**Barnes v. Community Trust Bank, Ky. App. 121 S.W. 3d 520 (2003)**

Here, the Kentucky Court of Appeals reversed a summary judgment granted to Community Trust Bank ("Community Trust") for a deficiency following the repossession and sale of a 1992 Toyota pickup under a retail installment contract. The action was filed by Community Trust five and a half years after it had repossessed and sold the truck.

The question raised on appeal was whether the statute of limitations set forth in KRS 355.2-725 (Kentucky's adoption of § 2-725 of the UCC) operated to bar Community Trust's action. KRS 355.2-725 provided that any action for breach of a contract for the sale of goods must be commenced within four years after the cause of action accrued.

Barnes argued that the statute barred Community Trust's action. Community Trust countered and argued that 355.2-725 did not apply to the sale of a motor vehicle, but that instead the 15-year statute applicable to written contracts applied. Community Trust relied on the definition of goods set forth in KRS 371.210, which excludes motor vehicles. The Court determined that 371.210 applied only to the sale of consumer goods and therefore did not apply to motor vehicles. However, the court also noted that the Kentucky Motor Vehicle Retail Installment Sales Act (KRS 190.090 et seq.) did not provide a remedy for an aggrieved seller or seller's assignee.

The court determined that the vehicle was a "good" under the UCC and the four-year statute of limitations applied and barred Community Trust's action.

**In re Robinson (Robinson v. Champagne Landmark), 330 F.3d 834 (6<sup>th</sup> Cir. 2003)**

The Sixth Circuit denied a pro se petition for rehearing of the court's prior decision affirming a bankruptcy court ruling that the debtor had not timely filed a proper motion to vacate or modify an arbitration decision and, therefore, the claim based on such decision would be allowed. The debtor claimed that since the creditor had filed an application to confirm the arbitration in state court and that the debtor had answered and counterclaimed to vacate the arbitration award, the court should deem that he did properly object to the award. However, the record was inadequate and conflicting. The court stated that it was unable "to divine the existence of actions that the record and briefs do not reflect and that counsel agree at oral argument have not occurred." The court stated that even if a proper motion to vacate had been filed, the court would nevertheless affirm allowance of the claim because no basis for vacating the arbitration award had been shown.

**In re Brookover, 352 F.3d 1083 (6<sup>th</sup> Cir. 2003)**

Here, the Sixth Circuit Court of Appeals held that the power to accept the voluntary resignation of a standing Chapter 12 Trustee is vested solely in the United States Trustee ("UST") and does not require approval by the bankruptcy court.

This case involved three cases filed under Chapter 12 of the Bankruptcy Code. The trustee for each case was Michael V. Demczyk ("Demczyk"). In October 2000, Demczyk tendered his resignation as standing trustee to the United States Trustee ("UST"). The UST sent a letter to Demczyk and the Court accepting his resignation. On November 28, 2000, the bankruptcy court issued an order in all three cases requiring court approval to effectuate Demczyk's resignation. The UST filed a motion to reconsider; it was denied. The UST appealed to the District Court; it affirmed the bankruptcy court's decision.

The question presented on appeal was who has the power to accept the voluntary resignation of the Chapter 12 Trustee, the UST or the Court. The Court held that the authority to accept the voluntary resignation of a bankruptcy trustee is vested entirely within the purview of

the UST's congressionally conferred authority. Further, the Court held that the law does not require the UST to submit the decision to the bankruptcy court for approval.

**In re Fowler, 2004 Bankr. LEXIS 67 (E.D. Ky. 2004)**

Here, the bankruptcy court denied the debtor's husband's motion to recuse the bankruptcy judge for being "biased and prejudiced" against him. The debtor was once married to Frederick Damron. During their divorce, a state court awarded the debtor real property and a vehicle. Damron appealed that order all the way to the United States Supreme Court where his petition for a writ of certiorari was denied.

Damron then attempted to file claims concerning the property in this bankruptcy action, and filed more than twenty motions attempting to stop the sale of the property in which he continued to claim an interest notwithstanding the ruling in the divorce proceeding. The court imposed sanctions of \$1,000 plus attorney fees, but Damron continued to file motions. The Trustee then filed a second motion for sanctions, at which time Damron filed a motion to recuse the judge. The court discussed both the standards for recusal and a judge's duty not to recuse based on irrational and unsupported allegations and accusations. The court denied the motion.

**In re Behlke (Behlke v. Eisen) 358 F 3d 429 (6<sup>th</sup> Cir. 2004)**

The Sixth Circuit affirmed the bankruptcy court's decision dismissing the voluntary Chapter 7 petition for "substantial abuse" under 11 U.S.C. § 707(b).

The debtors filed a "no asset" Chapter 7 proceeding. The trustee moved to dismiss on the ground that granting a discharge would constitute a substantial abuse of the Code because the debtors had disposable income that could be used to pay creditors. The stipulated facts in the case showed that debtor husband made voluntary monthly contributions of \$460 to his employer sponsored 401(k) plan. The bankruptcy court noted that substantial abuse can be based on a lack of honesty or a want of need. It included the 401(k) contributions in disposable income, found an ability to pay from future income and concluded that the debtors were not needy. The debtors appealed. The BAP and the Sixth Circuit affirmed.

First, the Sixth Circuit held that dismissals under § 707(a) and (b) were reviewable under an abuse of discretion standard as they are equitable determinations. With respect to the propriety of the dismissal, the court followed prior Sixth Circuit precedent which held that the most important factor to be considered in the "neediness" determination is the debtor's ability to repay debts from future earnings, which alone could be sufficient to warrant dismissal. The court rejected the debtors' argument that substantial abuse required evidence of unfair dealing or bad faith. The court also rejected the debtors' argument that it was error to include the 401(k) contributions in disposable income. The court noted that one way to determine ability to pay is to consider whether the debtors could fund a Chapter 13 plan. The court held that the retirement contribution was "disposable" because it was not necessary for "maintenance or support" of the debtors or their dependents, and the bankruptcy court's finding that they could fund a Chapter 13

plan -- with the anticipated retirement contributions -- would not be reversed as an abuse of discretion.

### **III. BANKRUPTCY LEGISLATION UPDATE**

- "Bankruptcy Abuse Prevention And Consumer Protection Act" (H.R. 975) (as of March 25, 2004)

- Passed by House in 2003. Not passed by Senate (abortion language dispute).
- Senate passed non-controversial extension of Chapter 12 (family farmers), and House has voted to combine it with main legislation.
- House GOP attempting to move legislation to conference in the Senate, even though Senate has not voted.
- Legislation could go to Senate floor for vote or to conference.

### **IV. SERVICEMEMBERS CIVIL RELIEF ACT**

The Servicemembers Civil Relief Act was enacted December 19, 2003 and applies to cases not final as of the enactment. Formerly known as the Soldiers' and Sailors' Civil Relief Act of 1940 (50 U.S.C. App. 501 et seq.), the Act is designed to protect service members from certain occurrences while they are on active military duty. Its principal features of interest to lenders include:

- Protection of service members from default judgments through use of plaintiff's affidavits, posting of bonds, ability to obtain stays and ability to have such judgments set aside;
- Protection of service members through availability of stays in proceedings of which they have notice and stays of execution;
- Abatement of certain contractual fines and penalties;
- Exclusion of military service periods for calculation of certain statutes of limitation and redemption periods;
- Forgiveness of interest in excess of 6%, on service members' notification of lender;
- Certain eviction protections;

- Protection from breaches of contracts including for purchase and lease of vehicles;
- Delay of foreclosure proceedings and permitted termination by the lessee of real property leases and vehicle leases;
- Protections that “may” be extended by a court to persons secondarily liable;
- Protections against waiver (service members and persons secondarily liable may waive certain rights but only effective if waiver is in writing and executed during or after the military service); and
- Protection from adverse insurance and credit decisions based on exercise of rights under the act.



# **CHECK CLEARING IN THE 21<sup>ST</sup> CENTURY ACT**

*Jane Hils Shea  
Frost Brown Todd LLC  
Cincinnati, Ohio*

Copyright 2004. Jane Hils Shea. All Rights Reserved.

**SECTION F**

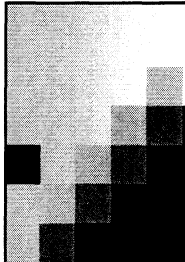




## **CHECK CLEARING IN THE 21<sup>ST</sup> CENTURY**

- I. POWERPOINT PRESENTATION ..... F-1**
  
- II. FEDERAL RESERVE SYSTEM, 12 CFR PART 229  
REGULATION CC; DOCKET NO. R-1176  
AVAILABILITY OF FUNDS AND COLLECTION OF CHECKS ..... F-15**
  
- III. CONFERENCE REPORT - 108<sup>TH</sup> CONGRESS, 1<sup>ST</sup> SESSION  
CHECK CLEARING FOR THE 21<sup>ST</sup> CENTURY ACT  
REPORT 108-291, OCTOBER 1, 2003 ..... F-43**





## Check Clearing in the 21st Century Act

Jane Hils Shea  
Frost Brown Todd LLC

---

---


---

---

---

---

---



## Check Clearing in the 21st Century Act

- Overview of the legislation
  - ☐ Signed on October 28, 2003 with an effective date of October 28, 2004
- Consideration of Legal Risk

---

---


---

---

---

---

---



## Major Provisions: Substitute Checks

- Substitute Check:
  - ☐ Act establishes a new negotiable instrument
  - ☐ Act is silent about electronic exchange (would still require an agreement)
- Substitute check is a paper reproduction of the original check and can be processed just like the original check
  - ☐ Must be MICR encoded and machine readable
  - ☐ Must include an image of the front and back of the original check
  - ☐ Must meet industry standards for substitute checks

---

---

---

---

---

---

---

## Scope

### ■ Definitions

- ☐ substitute check (§3(16))
- ☐ reconverting bank (§ 3(15))

---

---

---

---

---

---

---

## Scope

- The term "substitute check" means a paper reproduction of the original check that -
  - ☐ accurately represents all of the information on the front and back of the original check;
  - ☐ bears a MICR line containing all the information appearing on the MICR line of the original check, except as provided under generally applicable industry standards for substitute checks to facilitate the processing of substitute checks;

---

---

---

---

---

---

---

## Scope

- ☐ conforms, in paper stock, dimension, and otherwise, with generally applicable industry standards for substitute checks; and
- ☐ is suitable for automated processing in the same manner as the original check."
- Image statement will not qualify
- Copies in courier envelopes will not qualify
- No agreement needed to transfer a legally equivalent substitute check

---

---

---

---

---

---

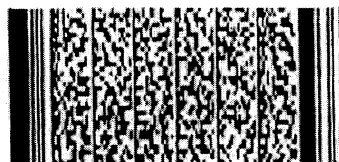
---

# Substitute Check Design

F-3

\*051000033\*  
09/18/2001  
3112003355102116

This is a legal copy of your  
check. You may use it the  
same way you would use the  
original check.



[121000374] 09/18/2001  
0025671467874451

John Q. Smith  
123 N. Elm Street  
Richmond, VA 23220

68-0038/510

1032

DATE Apr 12, 2001

PAY TO THE  
ORDER OF

International Books Co.

\$

165.00

One-hundred Sixty-five and no/100

DOLLARS

Security  
Feature  
Detailed  
on Back

Richmond's Best Bank  
Richmond, VA 23261

Memo

Books

John Smith

MP

⑆051000389⑆

28634832⑈

1032

⑆0000016500⑆

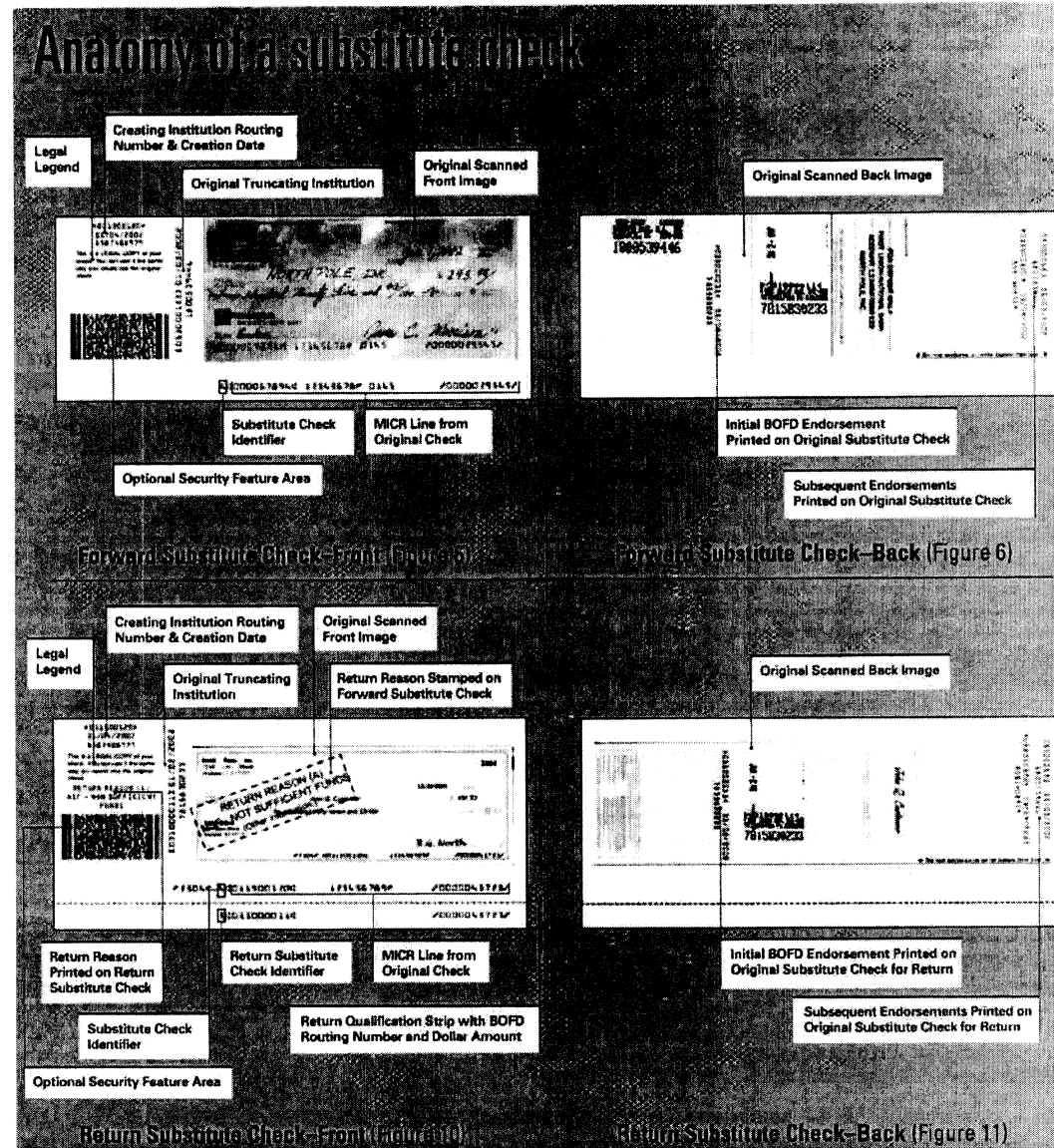
⑆051000389⑆

28634832⑈

1032

⑆0000016500⑆

# Substitute Check Design



## Substitute Check Design

"15180021"  
 000110001  
 J11203799579118  
 There is a legal copy of your  
 check. You may attach this  
 note only once to a single  
 original check.

15180021 000110001  
 15180021 000110001

John Q. Smith  
 123 N. Main Street  
 Richmond, VA 23100

15180021 000110001

PAID TO THE ORDER OF  
 International Books Co.  
 One hundred fifty-four and no/100  
 \$154.00

Signature of the Bank  
 John Smith

15180021 000110001 15180021 000110001

## Substitute Check Design

15180021 000110001  
 15180021 000110001

John Q. Smith  
 123 N. Main Street  
 Richmond, VA 23100

15180021 000110001

PAID TO THE ORDER OF  
 International Books Co.  
 One hundred fifty-four and no/100  
 \$154.00

Signature of the Bank  
 John Smith

15180021 000110001 15180021 000110001

## Major Provisions: Reconverting Bank

- The term "reconverting bank" means -
  - the bank that creates a substitute check; or
  - if a substitute check is created by a nonbank, the first bank that transfers or presents such substitute check.
- If you agree to allow your depositors to create substitute checks, you are still considered the reconverting bank, because you will fall within the second prong.

## Basic Principles

- No Agreement Between Banks Required:
  - A person may deposit, present, or send a substitute check for collection or return as long as the reconverting warranties under the Act are made. (§ 4(a)).
- If certain conditions are met, the substitute check is deemed to be the legal equivalent of the original check for all purposes. (§ 4(b))
  - accurately represents all information on front and back of the original check at the time the original check was truncated
  - bears a legend on legal equivalence
- The Act cannot be modified by agreement (§ 14), except for the part of the Act dealing with recredit procedures between banks. (§ 8)

---

---

---

---

---

---

---

---

## Major Provisions: What Law Applies?

- Existing check law applies if:
  - Substitute check is legal equivalent of original
  - Existing law is not inconsistent with Check 21 (§ 13)
  - For example:
    - UCC Articles 3 and 4:
      - UCC warranties
      - Midnight deadline
      - Charge customer only if properly payable
    - Federal Reserve Board's Regulation CC (Expedited Funds Availability Act)

---

---

---

---

---

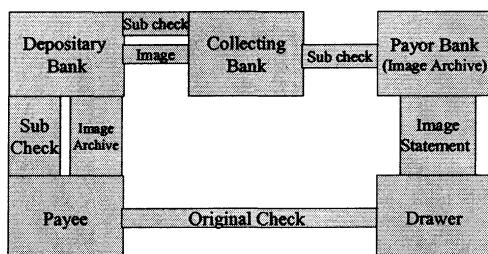
---

---

---

## Check Clearing in the 21st Century Act

Check 21 Work Flow




---

---

---

---

---

---

---

---



## New Obligations, Warranties and Indemnities

### ■ Obligations of a Reconverting Bank

- ☐ identify itself on substitute check and preserve any previous reconverting bank identification (§ 4(d))
- ☐ ensure that the substitute check bears all previous endorsements (whether in electronic form or otherwise) (§ 4(c))

---

---

---

---

---

---

---

## Major Provisions: New Obligations, Warranties and Indemnities

- All of the warranties, indemnities and recredit rights created under C21 start at the "reconverting" bank as opposed to the bank that imaged the items (unless they are the same entity) (§5, §4)
  - ☐ If you are a reconverting bank, you will likely need to revise any agreements about electronic collection or presentment so that C21 liability falls appropriately

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New Substitute Check Warranties

- ☐ Reconverting and all subsequent banks warrant: The substitute check meets all of the requirements of legal equivalency (§ 5(1))
  - accurately represents all of the information on the front and back of the original check as of the time at which the original check was truncated; and
  - bears the legend: "This is a legal copy of your check. You can use it the same way you would use the original check."

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New Substitute Check Warranties

- ☐ Future Conditions: No depositary bank, drawee, drawer or endorser will be asked to make payment based on a check it has already been paid (no double debit). (§ 5(2))
- ☐ Warranties "run with the check"
- ☐ Warranties run regardless of whether warrantee receives the substitute check

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New Substitute Check Warranties: To whom are they made? (§ 5)

- ☐ the transferee, any subsequent collecting or returning bank, the depositary bank, the drawee, the drawer, the payee, the depositor, and any endorser
- ☐ theory is to put customer in same position as if he or she had received the original check

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New Indemnity (§ 6):

- ☐ A reconverting bank and each bank that subsequently *transfers, presents or returns* a substitute check and *receives consideration*
- ☐ indemnifies the transferee, any subsequent collecting or returning bank, the depositary bank, the drawee, the drawer, the payee, the depositor, and any endorser
- ☐ to the extent of any loss incurred by any recipient of a substitute check if that loss occurred due to the receipt of a substitute check instead of the original.

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New Indemnity: Limits

- ☐ The amount of the indemnity (§ 6(b)) depends on whether there was a substitute check warranty breach

- No warranties breach:

- ☐ the amount of any loss (up to the amount of the substitute check) plus interest and expenses

- Warranty Breach:

- ☐ the amount of any loss (including costs and expenses) proximately caused by the breach.

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New Indemnity: Limits

- ☐ Comparative negligence principles apply (§ 6 (c))
  - but comparative negligence provision does not reduce the rights of any party under the UCC or other applicable law

- ☐ Production of original check or copy sufficient to determine whether a claim is valid (§ 6(d))

- liability is limited to losses incurred up to the time the original check or copy was provided
  - indemnifying party has the right to the return of any payment made under the indemnity in excess of this liability
  - production of the check or copy does not absolve the bank from liability on a warranty

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

- Damages for breach of a substitute check warranty or failure to comply with a requirement of the Act (§ 10)

- ☐ Except as provided in section 6 (indemnity claim),

- the lesser of the amount of the loss suffered as a result of the breach or failure or the amount of the substitute check, plus
  - interest and expenses including attorney's fees

- ☐ Comparative negligence principles apply

- but comparative negligence provision does not reduce the rights of any party under the UCC or other applicable law

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New expedited recredit right for consumers (§ 7) (on top of UCC 4-401/4-406)

- ☐ consumer may claim a recredit of a charge to the consumer's account if the consumer asserts item is not properly payable or there is a breach of C21 warranty, the substitute check was provided to the consumer, and the original or better copy is needed to resolve claim
- ☐ request must be made within a 40-day period from date bank mails or delivers relevant statement or date substitute check is made available to customer
- ☐ recredit must be given if the bank does not provide the original check, a substitute check or copy and demonstrate that the substitute check was properly charged to the account

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New expedited recredit for consumers: What must bank do?

- ☐ Timing of Recredit (§ 7(c))
  - If claim is valid : no later than the end of the business day following the business day on which the bank determines the consumer's claim is valid
  - If investigation takes longer than 10 days:
    - ☐ up to \$2,500 recredit by the 10th business day after claim
    - ☐ remainder of claim by the 45th calendar day
    - ☐ plus interest (in both cases) for interest-bearing account

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New expedited recredit right for consumers

- ☐ Availability (§ 7(d))
  - recredited funds must be made available for withdrawal on the next business day after the day of recredit
  - Except that availability of a recredit made pending a determination can be delayed until the 45th calendar day following the business day on which the claim was submitted for
    - ☐ new accounts (less than 30 days old)
    - ☐ repeated overdrafts (negative balance on 6 or more days during past 6 months)
    - ☐ prevention of fraud losses (reasonable grounds to believe claim is fraudulent)

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New expedited recredit right for consumers

- ☐ A bank may reverse a recredit if it (§ 7(e)):
  - determines substitute check was properly payable and
  - notifies the consumer

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New expedited recredit right for banks (§ 8)

- ☐ Variable by agreement
- ☐ Similar rules to those of consumers except:
  - claim is made against an indemnifying bank
  - triggered by a consumer recredit claim
  - longer period to submit claim (120 days after transaction)
  - if a copy of a substitute check is submitted as part of claim, claimant must take steps to ensure that it will not be mistaken as an actual live item

---

---

---

---

---

---

---

## New Obligations, Warranties and Indemnities

### ■ New expedited recredit right for banks

- ☐ Similar rules to those of consumers except:
  - indemnifying bank must provide original check or sufficient copy or recredit within 10 business days
  - alternatively, indemnifying bank can indicate why it is not required to produce check or recredit
  - if the indemnifying bank produces the original check (or sufficient copy), it is entitled to a repayment of the amount of any recredit less any losses covered by the indemnity that were incurred up until the time that the original (or copy) is provided (example, losses caused by wrongful dishonor due to paying a substitute check that was not properly payable)
  - claimant bank has refund obligation if it recovers from its customer

---

---

---

---

---

---

---

## Major Provisions: Consumer Notices

- Notices related to expedited recredit claims:
  - ☐ Claim found invalid
  - ☐ Recredit given or reversed
- General notice
  - ☐ Describing how substitute check is legal equivalent and consumer recredit rights
  - ☐ Given to customers who get checks back
    - Existing customers: first mailing after effective date
    - New customers: at time relationship is initiated
  - ☐ Board to publish model language

---

---

---

---

---

---

---

## Other Provisions

- Delays for emergency (§ 9)
- Statute of limitations (1 year) and notice of claims (§ 11)
- Consumer awareness (§ 12)
- Regulations (§ 15)
  - ☐ Board of Governors authorized to promulgate regulations that "implement, prevent circumvention or evasion of, and facilitate compliance with the provisions of the Act"
  - ☐ Proposed regulations published by Federal Reserve 12/22/03 - comment period ended on 3/12/04 - 106 comment letters received by Fed

---

---

---

---

---

---

---

## Other Provisions

- C21: The Board of Governors must study (§ 16) among other things:
  - ☐ the appropriateness of the time periods and amount limits applicable under EFAA and report to Congress within 30 months from effective date of C21 Act
- EFAA: Already requires the Board of Governors:
  - ☐ to reduce the statutory schedules for any category of checks where most of those checks would be returned in a shorter period of time than provided in the schedules.

---

---

---

---

---

---

---

## Consideration of Legal Risk

- Fair degree of uncertainty as to how the Act will work from a legal perspective
- Legal Risk Analysis - All Banks:
  - Substitute check warranties and indemnity – completely new
  - Expedited Recredit Right/Indemnity
    - some drawers may demand original to obtain float
    - loss of information on original item
    - new fraud risk
    - increased litigation costs

---

---

---

---

---

---

---

## Consideration of Legal Risk

- What do banks need to do?
  - Consumer Awareness Notices
    - Allocate liability under electronic exchange agreements
    - Renew quality control procedures
    - Consider loss of information
    - MICR repair
    - comparative negligence
  - Other Liability?
    - Losses caused by failure to identify reconvert bank
    - Losses due to a failure to show prior endorsements

---

---

---

---

---

---

---

## Consideration of Legal Risk

- Unintended Consequences under UCC 3/4
  - multiple holders in due course
    - unknowable number of copies that are "the check" and all can be held by HDC
  - Price v. Neal
  - merger and suspension and discharge
    - how do the traditional rules work?
  - Standards of care
    - Does good faith change?
    - Does handling an item with ordinary care change?

---

---

---

---

---

---

---

## Check 21 - The Benefits

- Removes legal barriers to truncation
- Reduces dependence on physical transportation
- Encourages (but does not authorize) check "electronification"
- Retains customers' ability to receive canceled checks
- Positions the banks to provide new and improved services to customers

---

---

---

---

---

---

---



## **FEDERAL RESERVE SYSTEM**

### **12 CFR Part 229**

#### **Regulation CC; Docket No. R-1176**

#### **Availability of Funds and Collection of Checks**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Proposed rule.

**SUMMARY:** The Board of Governors is publishing for comment proposed amendments to Regulation CC that would add a new subpart D, with commentary, to implement the recently-enacted Check Clearing for the 21<sup>st</sup> Century Act. These proposed amendments (1) would set forth the requirements of the Act that apply to banks, (2) provide a model disclosure and model notices relating to substitute checks, and (3) set forth indorsement requirements and truncating bank and reconvert bank identification requirements for substitute checks. The proposed amendments also would clarify some existing provisions of the rule and commentary.

**DATES:** Comments on the proposed rule must be received by March 12, 2004.

**ADDRESSES:** Comments should refer to docket number R-1176 and should be addressed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System. Comments may be mailed to 20<sup>th</sup> Street and Constitution Avenue, N.W., Washington, D.C., 20551; faxed to the Office of the Secretary at 202/452-3819 or 202/452-3102; or mailed electronically to [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Because paper mail at the Board of Governors is subject to delay, please consider submitting your comments by fax or e-mail. Members of the public may inspect comments in accordance with the Board's Rules Regarding the Availability of Information (12 CFR part 261) in Room MP-500 of the Martin Building on weekdays between 9:00 a.m. and 5:00 p.m.

**FOR FURTHER INFORMATION CONTACT:** Jack K. Walton, II, Assistant Director (202/452-2660), or Joseph P. Baressi, Senior Financial Services Analyst (202/452-3959), Division of Reserve Bank Operations and Payment Systems; or Stephanie Martin, Associate General Counsel (202/452-3198), or Adrienne G. Threatt, Counsel (202/452-3554), Legal Division; for users of Telecommunication Devices for the Deaf (TDD) only, contact 202/263-4869.

## SUPPLEMENTARY INFORMATION:

### Background

#### *I. The Need for and General Provisions of the Check 21 Act.*

Under current law, a bank that presents a check for payment must present the original paper check unless the paying bank has agreed to accept presentment from the collecting bank in some other form.<sup>1</sup> Sections 3-501(b)(2) and 4-110 of the Uniform Commercial Code (U.C.C.) specifically authorize banks and other persons to agree to alternative means of presentment, such as electronic presentment. However, to truncate checks early in the collection process and engage in broad-based electronic presentment, a collecting bank would need electronic presentment agreements with each bank to which it presents checks. This has proven impracticable because of both the large number of paying banks and the unwillingness of some paying banks to receive electronic presentment.<sup>2</sup> As a result of the difficulty in obtaining the agreements necessary to present checks electronically in all cases, banks have not been able to take full advantage of the efficiencies and potential cost savings of handling checks electronically.

The Check Clearing for the 21st Century Act (the Check 21 Act or the Act) facilitates the broader use of electronic check processing without mandating that any bank change its current check collection practices.<sup>3</sup> The Check 21 Act accomplishes this by authorizing the use of a new negotiable instrument called a substitute check. A substitute check is a paper reproduction of an original check that contains an image of the front and back of the original check and is suitable for automated processing in the same manner as the original check. A bank that for consideration transfers, presents, or returns a substitute check (or another paper or electronic representation of a substitute check) warrants that (1) the substitute check contains an accurate image of the front and back of the original check and a legend stating that it is the legal equivalent of the original check, and (2) no depository bank, drawee, drawer, or indorser will be asked to pay a check that it already has paid. A substitute check for which a bank has made these warranties is the legal equivalent of the original check for all purposes and all persons.

Allowing a substitute check that is subject to the substitute check warranties to be the legal equivalent of an original check should facilitate the use of electronics in the check collection process. For example, a depository bank in California that receives a check drawn on a bank in New York now must present the original paper check for payment absent an agreement to the contrary, even if the California bank has agreements

---

<sup>1</sup> See, e.g., § 3-501(b) of the Uniform Commercial Code.

<sup>2</sup> Some paying banks and bank customers prefer to receive checks in paper form for operational or other reasons.

<sup>3</sup> Pub. L. No. 108-100, 117 Stat. 1177 (codified at 12 U.S.C. §§ 5001-5018). The Check 21 Act was enacted on October 28, 2003, and takes effect on October 28, 2004.

to collect checks electronically with other banks in the collection chain for that check. Under the Check 21 Act, by contrast, the California bank could transfer check information electronically to a collecting bank in New York with which it had an agreement to do so. The New York collecting bank then could create a substitute check to present to the New York paying bank. The New York paying bank would be required to accept a substitute check that met all the legal equivalence requirements. Thus, instead of processing and transporting the original check across the country, the California bank could collect the substitute check using only local New York transportation.

The Check 21 Act does not require any bank to use electronic check processing, receive electronic presentment, or create substitute checks, nor would the Check 21 Act make electronic check images or electronic check information the legal equivalent of original checks. However, after the effective date of the Check 21 Act, any bank or other person that requires an original check must accept a legally equivalent substitute check in satisfaction of that requirement. The characteristics of a substitute check are such that a bank that receives a substitute check would be able to process that substitute check to the same extent that it could process the original check. As a result, for the most part, banks would not be required to change their check processing equipment or practices because of the Check 21 Act, and there would be no need for a bank to sort original checks and substitute checks separately during the check collection process.<sup>4</sup>

Certain provisions of the Check 21 Act will affect all banks, even those that do not choose to create substitute checks. For example, a bank that simply received a substitute check created by another bank, or a paper or electronic representation of a substitute check, would make the substitute check warranties when it delivered that item for presentment, collection, or return or provided that item to its customer.

The [REDACTED]  
 [REDACTED]  
 [REDACTED]  
 [REDACTED] M [REDACTED]  
 re [REDACTED] the consumer if the consumer is injured  
 due [REDACTED]  
 p [REDACTED] check in [REDACTED]  
 c [REDACTED]  
 c [REDACTED]

Although the foregoing provisions of the Check 21 Act would apply to all banks, the ~~banking system would be required to~~ with a substitute check ultimately would be ~~the same as the original check~~ with the substitute check. In many cases this

<sup>4</sup> However, as described in more detail in the section-by-section analysis, a bank must place a “5” in position 44 of the MICR line of a qualified returned substitute check, as opposed to a “2” that is required in that position for a qualified returned original check.

would be the first bank to transfer the substitute check (the reconvertor).<sup>5</sup> A bank that paid a warranty claim or provided an indemnity or expedited recredit for a substitute check that it received from another bank therefore could, in turn, bring a warranty, indemnity, or interbank expedited recredit claim against the bank that transferred the substitute check to it and thereby pass the associated loss back to the responsible party.<sup>6</sup>

*just like  
neg instr  
law*

~~The Check 21 Act imposes additional duties on reconverting banks.~~ A reconverting bank must identify itself as such on a substitute check and must preserve the indorsements of parties that previously handled the check in any form. The reconverting bank will be the first bank to provide the substitute check warranties and the first bank in the chain of indemnifying banks, and thus ultimately should bear any loss traceable to a problem that existed as of the time the substitute check was created.<sup>7</sup>

## II. Overview of New Subpart D and Associated Amendments to Subpart A.

~~The Board~~ would incorporate into Regulation CC the requirements of the Check 21 Act that affect banks that create or receive substitute checks or paper or electronic representations of substitute checks. Subpart D therefore would contain provisions concerning requirements a substitute check must meet to be the legal equivalent of an original check, reconverting bank duties, the warranties and indemnity associated with substitute checks, expedited recredit procedures for consumers and banks, liability for violations of subpart D, the interaction between subpart D and existing federal and state laws, and the consumer awareness disclosure and other notices regarding substitute checks.

The proposed amendments to implement the Check 21 Act also affect some existing provisions of Regulation CC and its commentary. For example, the Board proposes to amend the authority and scope section, § 229.1, to acknowledge the Check 21 Act as an authority source and to describe subpart D. The Board also proposes to supplement some existing defined terms in § 229.2 for which the Check 21 Act has slightly different definitions and to define several new terms used in subpart D.

~~The Board also proposes to amend the authority and scope section, § 229.1, to acknowledge the Check 21 Act as an authority source and to describe subpart D. The Board also proposes to supplement some existing defined terms in § 229.2 for which the Check 21 Act has slightly different definitions and to define several new terms used in subpart D.~~

<sup>5</sup> A reconverting bank is (1) the bank that creates a substitute checks or (2) the first bank that receives a substitute check created by a person that is not a bank and transfers either that substitute check or a paper or electronic representation of that substitute check.

<sup>6</sup> Banks may further allocate liability amongst themselves as part of their agreements to handle checks electronically. A reconverting bank therefore could, by agreement, pass back some or all of its loss associated with paying a warranty or indemnity to the bank that sent the check to it electronically.

<sup>7</sup> But see footnote 6.

### III. *Other Amendments to Existing Provisions.*

The Board also proposes revisions to several other provisions of Regulation CC and its commentary. These changes generally either respond to enquiries that Board staff has received or respond to changed circumstances affecting the relevant provision. For example, the Board proposes amending the commentary to clarify that a returned check notice need not be written, clarify the time by which a paying bank may extend the return or notice of nonpayment deadline, and clarify the time by which a paying bank may extend the return or notice of nonpayment deadline.

#### **Section-by-Section Analysis**

The section-by-section analysis discusses the proposed commentary to each section in the course of discussing the proposed regulatory text.

#### *I. Amendments to Implement the Check 21 Act.*

##### **A. Section 229.1 Authority and Scope.**

The Board proposes to amend § 229.1 to include the Check 21 Act as an additional source of authority and to describe briefly the scope of new subpart D with respect to substitute checks.

##### **B. Section 229.2 Definitions.**

The Board proposes two types of amendments to this section. First, the Board proposes to amend some existing defined terms to account for differences between those definitions and the definitions required by the Check 21 Act.<sup>8</sup> Second, the Board proposes to define new terms used in subpart D.

#### **1. Amendments to Existing Definitions.**

The Board proposes to reword the existing introductory sentence and move into that sentence the text of existing § 229.2(qq), which provides that terms not defined in § 229.2 have the meanings set forth in the U.C.C.

a. *Account.* The Check 21 Act defines the term account to mean any deposit account at a bank and therefore is much broader than the existing definition in § 229.2(a), which essentially is limited to accounts that permit frequent transfers and withdrawals. The Board therefore proposes to amend the account definition to state that the existing definition applies except for purposes of subpart D. The Board proposes a new paragraph defining the term account for purposes of subpart D and, in connection therewith,

---

<sup>8</sup> Some terms are defined identically in existing Regulation CC and the Check 21 Act, such that no amendments are necessary.

subpart A, to mean any deposit, as defined at § 204.2(a)(1)(i) of Regulation D, at a bank. The Board also proposes to amend the commentary to the account definition to incorporate these changes and to highlight that many deposits that are not accounts for purposes of subparts B and C would be accounts for purposes of subpart D.

b. *Bank.* The Check 21 Act defines bank to include all of the entities currently defined as banks by § 229.2(e), plus the United States Treasury and the United States Postal Service to the extent that those entities act as payors. The Board proposes to amend the existing definition and its commentary to incorporate the broader definition of bank for purposes of subpart D. For internal consistency, the Board proposes substituting the phrase “paying bank” where the Check 21 Act used the term “payor.”

c. *Check.* The Check 21 Act’s definition of check is the same as the definition in existing § 229.2(k) that applies to subpart C. The Board proposes to amend the subpart C definition of check and its commentary to apply to both subparts C and D. The proposed commentary to this definition states that a substitute check meeting the requirements of § 229.2(z) is a check for purposes of all provisions of Regulation CC.

d. *Forward collection.* The term forward collection is defined in § 229.2(q) to mean the process by which a bank sends a check on a cash basis to the paying bank for payment. The Check 21 Act’s definition is substantively the same as the existing definition but includes a clause noting that sending a check to a collecting bank for settlement can be a component of forward collection. The Board proposes to amend the forward collection definition and commentary to include that clause.

e. *Paying bank.* The Check 21 Act’s definition of paying bank essentially parallels the definition in § 229.2(z) but adds the U.S. Treasury and the U.S. Postal Service with respect to a check that is payable by one of those entities and is sent to that entity for collection. The Board therefore proposes to amend § 229.2(z) and the commentary thereto to incorporate the broader definition of paying bank in subpart D.

f. *Qualified returned check.* Although the definition of a qualified returned check in § 229.2(bb) remains unchanged by the Check 21 Act, the Board proposes to amend the commentary to that definition as it relates to the content of position 44 of the MICR line. Currently, the commentary notes that a qualified returned check should have a “2” in position 44. The proposed amendment would retain that requirement for original checks but, in accordance with the generally applicable industry standard for substitute checks (American National Standard Specifications for Image Replacement Documents, X9.90 (ANS X9.90)), would require a “5” in position 44 if the qualified returned check is a substitute check.<sup>9</sup> The “5” would ensure that the size of the image of the original check would remain constant on subsequent substitute checks.

---

<sup>9</sup> ANS X9.90 was in draft form on the date that the Board approved this proposed rule. The Board expects that ANS X9.90 will be final on or before October 28, 2004.

g. *State*. The Check 21 Act defines state to include all the entities that are currently listed in § 229.2(ff), plus Guam, American Samoa, the Trust Territory of the Pacific Islands, the Northern Mariana Islands, and any other territory of the United States. The Board therefore proposes to supplement the existing definition of state by including these additional entities as states for purposes of subpart D.

## 2. Proposed New Definitions.

a. *Claimant Bank*. The term claimant bank is used in section 8 of the Check 21 Act regarding expedited recredit claims by banks, although the statute does not define that term. The Board proposes to define the term claimant bank in § 229.2(qq) to mean a bank that submits a claim for recredit under § 229.55 of Regulation CC, which corresponds to section 8 of the statute.

b. *Collecting bank, consumer, customer, and indemnifying bank*. The Board proposes to define the terms collecting bank, consumer, customer, and indemnifying bank at § 229.2(rr), (ss), (tt), and (uu), respectively. The proposed definitions incorporate the Check 21 Act definitions with only minor grammatical variations from the statutory language.

c. *Magnetic ink character recognition (MICR) line*. The Board proposes to incorporate the Check 21 Act's definition of magnetic ink character recognition (MICR) line in § 229.2(vv). The proposed commentary would note that American National Standard Specifications for Placement and Location of MICR Printing, X9.13 (ANS X9.13) is the governing standard for MICR lines of original checks and substitute checks, and that ANS X9.90 has some additional requirements regarding the content of the MICR line of a substitute check.

d. *Original check*. The Board proposes to define the term original check in § 229.2(ww) as the first paper check that is issued with respect to a particular payment transaction. The proposed commentary to this new definition explains that the Board has defined this term in order to distinguish the original check from a substitute check and from other paper or electronic representations of a check.

e. *Person*. The Board proposes to incorporate the Check 21 Act's definition of person in § 229.2(xx).

f. *Reconverting bank*. The Board proposes to define reconverting bank in § 229.2(yy) to be (1) the bank that creates a substitute check or (2) with respect to a substitute check created by a person that is not a bank, the first bank that receives the substitute check and that transfers, presents, or returns the substitute check or, in lieu of that substitute check, the first paper or electronic representation of that substitute check. The proposed commentary to this definition provides further clarification as to when and where creation of a substitute check occurs and explains that a bank need not accept a substitute check that was created by a nonbank and that has not yet been handled by a bank, unless the bank agrees to do so. Moreover, the proposed commentary provides

examples of when a bank would be a reconverting bank under the definition and notes that there could be multiple reconverting banks with respect to the same payment transaction if a check moves from electronic form to substitute check form multiple times throughout the collection and return process.

g. *Substitute check.* The Board proposes to incorporate the Check 21 Act's definition of substitute check in § 229.2(zz).

The scope of the Check 21 Act and subpart D is limited to substitute checks. To clarify the scope of the term and the subpart, the Board proposes extensive commentary on the definition of substitute check. The proposed commentary provides guidance on the meaning of a "paper reproduction of an original check" and clarifies that, because a substitute check by definition must be a piece of paper, an electronic check file or electronic check image that has not been printed in accordance with the substitute check definition and generally applicable industry standards is not a substitute check. The commentary also explains what information is required or permitted as part of the original check images that are contained on a substitute check.

The Board particularly requests comment on the proposed commentary to the substitute check definition that describes the various ways in which the MICR line of a substitute check can vary from the MICR line of the original check. First, the commentary notes that ANS X9.90 requires the content of position 44 of the MICR line of a substitute check to vary from that of position 44 of the original check to ensure that the check image remains constant if more than one substitute check is created to represent the same original check.

Second, the commentary acknowledges that the original check could have an encoding error in the amount field (including a failure to encode) and that a substitute check that reproduces that error would meet the definition of a substitute check. However, the commentary notes that a reconverting bank that creates a substitute check from an original check with a misencoded amount field or a bank that handles a substitute check that perpetuates the amount encoding error may repair the MICR line to facilitate the processing of the check without changing the item's status as a substitute check. This approach would be consistent with the current industry practice of allowing a bank to repair the MICR line of an original check when the bank detects an encoding error in the amount field.

Third, the commentary notes that the MICR line of the original check could be accurate in every respect but that check imaging equipment could (1) fail to read a portion of the MICR line but note the presence of MICR information with an asterisk, (2) misread a digit in the MICR line, for example by reading an "8" as a "3," or (3) intentionally read a space or a placeholder, such as a hyphen, to be a "0." These errors collectively are referred to as MICR-read errors. To ensure that the items a bank transfers in reliance on the Check 21 Act and subpart D meet the definition of a substitute check, the commentary states that before a reconverting bank creates a substitute check it



should correct all MICR-read errors.<sup>10</sup> The proposed commentary would clarify that an item that perpetuated a MICR-read error would not be a substitute check as defined in § 229.2(zz). However, as discussed in connection with § 229.51(c) of the proposed rule and the proposed commentary to that section, the Board proposes that, when such a noncompliant item purports to be a substitute check, the substitute check warranties, indemnity, and recredit rights would apply to that item as if it were a substitute check, even though it would not be the legal equivalent of the original check. The Board proposes this approach in order to facilitate compliance with and prevent circumvention and evasion of the Check 21 Act.

h. *Sufficient copy and copy.* The Board proposes that § 229.2(aaa) would define a sufficient copy to be a copy of an original check that accurately represents the information on the front and back of the original check as of the time of truncation or otherwise is sufficient to determine the validity of a claim. This concept first appears in section 6(d)(1) of the Check 21 Act regarding what a bank must produce to limit its liability for an indemnity claim. The concept also appears in the Check 21 Act (with minor variations) in sections 7(c)(1)(B) and 8(c)(1)(A) regarding what a bank must produce to avoid making a recredit and in section 7(f)(1)(A) regarding the content of the bank's notice regarding denial of a consumer recredit claim. To streamline the regulation and make the various sufficient copy criteria parallel throughout the rule, the rule defines sufficient copy as it is defined in the indemnity section and uses that defined term in the portions of the rule that correspond to the statutory provisions listed above. The Board proposes to define a copy to be a paper reproduction of a check.<sup>11</sup> The proposed commentary to these terms reiterates that an electronic check image that appears on a computer screen but has not yet been printed does not constitute a copy or a sufficient copy. The commentary also provides examples of what types of documents would constitute a sufficient copy.

i. *Transfer and consideration.* The Board proposes to define transfer and consideration at § 229.2(bbb) in a manner that supplements the U.C.C. definitions of those terms in order to make the warranty, indemnity, and legal equivalence provisions function as contemplated in the Check 21 Act.

The Check 21 Act warranties, which are a precondition for the legal equivalence of a substitute check, and the indemnity, are given when a substitute check or representation thereof is transferred, presented, or returned for consideration. Under the existing U.C.C. definitions, a bank that pays a substitute check that it later provides to the drawer or a bank that pays a check presented electronically and then creates a substitute

---

<sup>10</sup> American National Standards Specifications for Electronic Exchange of Check and Image Data, X9.37, (ANS X9.37), is being amended to address the identification and repair of MICR-read errors that are indicated with asterisks. The Board expects this amendment to be finalized prior to the effective date of the Check 21 Act.

<sup>11</sup> As explained in the analysis of § 229.58, when a bank is required to produce an original check or a sufficient copy, the rule allows a bank to provide an electronic image of that item if the recipient has agreed to receive that information electronically.

check to give to the drawer would not be transferring the check to the drawer under the U.C.C. and arguably would not receive consideration for the substitute check from the drawer. However, the Check 21 Act explicitly provides that a drawer receives the substitute check warranties if it receives a substitute check or a paper or electronic representation of a substitute check. The Check 21 Act also provides that a drawer who suffers a loss due to the receipt of a substitute check instead of the original check receives an indemnity. These provisions indicate that the substitute check received by the drawer in the examples provided above is intended to be the legal equivalent of the original check and subject to the warranties and indemnity.

Therefore, for the limited purpose of making the warranty, indemnity, and legal equivalence sections work as intended, the proposed rule would expand the term transfer to include delivery of a substitute check (or a paper or electronic representation of a substitute check) by a bank to a person that is not a bank. The proposed rule also would expand the term consideration to include the bank's charging, having the right to charge, or otherwise receiving value for a substitute check (or a paper or electronic representation of the substitute check) that the bank transfers. However, the proposed rule would explicitly exclude from the definition of consideration the transfer of a substitute check solely in response to a claim related to that substitute check.<sup>12</sup> The proposed commentary to the transfer and consideration definitions provides examples of the situations the expansion is designed to capture.

j. *Truncate*. The Board proposes to incorporate the Check 21 Act's definition of truncate in § 229.2(ccc). The proposed commentary highlights that removal of a substitute check is not truncation because truncation refers only to original checks.

k. *Truncating bank*. The Board proposes to define in § 229.2(ddd) the term truncating bank, which is not used in the Check 21 Act but is used in § 229.51 and appendix D of the proposed rule. The Board proposes to define truncating bank (in a manner that parallels the definition of reconverting bank) to be the bank that truncates the original check or, if a person other than a bank truncates the check, the first bank that transfers, presents, or returns the check in a form other than the original check. The proposed commentary to this section provides an example of when a bank would be a truncating bank.

---

<sup>12</sup> A bank should be able to produce a substitute check that does not contain the legal equivalence legend as a "sufficient copy" in response to an indemnity or recredit claim. However, if this were considered a transfer for consideration, the bank would be making the substitute check warranties and thus could not in good faith provide a substitute check without a legend, because by doing so it automatically would have breached the legal equivalence legend component of the legal equivalence warranty.

C. Section 229.30 Paying Bank's Responsibility for Return of Checks, and  
Section 229.31 Returning Bank's Responsibility for Return of Checks.

The Board proposes to revise existing sentences in §§ 229.30(a)(2)(iii) and 229.31(a)(2)(iii) relating to the proper MICR-line encoding of a qualified returned check. These amendments would specify that a qualified returned substitute check must contain a "5" in position 44 of the MICR line, whereas a qualified returned original check must contain a "2" in that position. As discussed above with respect to the definition of a qualified returned check and the definition of substitute check, a substitute check must contain a different number to ensure that the image of the original check remains a constant size. The Board proposes to move the specific references to ANS X9.13 from the regulation text to the commentary of these two paragraphs and specify that this standard applies to original checks. The commentary to each paragraph also would specify that ANS X9.90 is the standard that applies to substitute checks.

D. Indorsement Standards: Sections 229.35(a) and 229.38(d) and Appendix D.

In the current processing environment, banks generally print or "spray" indorsements on original checks when the checks are processed through the banks' automated check sorters. A substitute check will contain previous indorsements physically applied to the original check by preserving the image of the back of the original check. In addition, the reconverting bank will print, or "overlay," on the back of the substitute check any previous indorsements that were applied to the original check electronically and the reconverting bank's own indorsement. Banks handling checks downstream from reconverting banks generally will process a mix of original checks and substitute checks through their sorters and spray indorsements on both.

ANS X9.90 presumes that banks that receive paper checks, including substitute checks, will continue to spray indorsements on those checks in the same locations that they do today. ANS X9.90 also presumes that indorsements physically applied to a check before it is reconverted will be preserved through the accurate image of the back of the check that a substitute check must contain. However, the locations that ANS X9.90 specifies for previously applied electronic indorsements that a reconverting bank physically overlays on substitute checks and for the reconverting bank's own indorsement differ from the indorsement locations specified in current appendix D. In particular, the current appendix requires the depository bank indorsement to be placed on the back of the check between 3 inches from the leading edge and 1.5 inches from the trailing edge, whereas ANS X9.90 requires a depository bank's previously applied electronic indorsement to be overlaid by the reconverting bank on the back of a substitute check between 1.95 and 2.55 inches from the leading edge.<sup>13</sup> The current appendix requires a subsequent collecting bank indorsement to be placed on the back of the check between the leading edge and 3.0 inches from the leading edge, whereas ANS X9.90

---

<sup>13</sup> When looking at a check from the front, the leading edge is the right edge of the check and the trailing edge is the left edge of the check.

requires a subsequent collecting bank's previously applied electronic indorsement to be overlaid by the reconverting bank on the back of a substitute check very close to the trailing edge.

The Board believes that, in light of technical constraints, existing check sorting equipment will not be able to modify in real time the location of the indorsements that the equipment sprays onto a check based on whether the check is an original check or a substitute check. The Board therefore proposes that the appendix's current location specifications would apply to indorsements printed on original checks and indorsements printed on existing substitute checks. Banks that do not create substitute checks generally would comply with the amended appendix D requirements by indorsing original checks and existing substitute checks exactly as they indorse original checks today. However, the Board proposes to amend appendix D to include new indorsement locations with which a reconverting bank must comply when it creates a substitute check. These locations would conform to ANS X9.90's location specifications for indorsements applied to a substitute check by a reconverting bank.

The Board also notes that ANS X9.90 provides that an image of an original check will be reduced in size when placed on a substitute check. Images of business-sized checks will be reduced to about 65 percent of their original size and images of personal-sized checks will be reduced to about 80 percent of their original size. Because of this size reduction, the location of an indorsement, particularly a depositary bank indorsement, sprayed on an original paper check likely will change when a reconverting bank creates a substitute check that contains that indorsement within the image of the original paper check. The Check 21 Act places ultimate liability on the reconverting bank for certain losses related to substitute checks. The Board believes that the reconverting bank also should bear the liability under § 229.38(d)(1) (which allocates liability for losses due to illegible indorsements) for any loss that results due to the shift in the placement of the indorsement. The Board proposes to amend that section and its commentary to explain this reconverting bank liability.

Appendix D currently requires depositary bank indorsements to be printed in dark purple or black ink and requires all other indorsements to be printed in an ink color other than purple. The Board does not believe that the use of differing ink colors significantly aids returning banks' ability to identify the depositary bank indorsement. However, the Board does believe that it is important for all indorsements to be printed in dark ink so that they can be easily read and imaged. The Board further believes that all indorsements that a reconverting bank prints onto a substitute check at the time that the substitute check is created will be printed in a single ink color, likely black. The Board therefore proposes to require all indorsements, including the depositary bank indorsement, to be printed in black ink.

Current appendix D requires a depositary bank to include its name and location in its indorsement. However, ANS X9.37 does not include this data in an electronic depositary bank indorsement record, and as a result this data will not be included when a reconverting bank overlays a depositary bank indorsement onto a substitute check.

Nevertheless, a depository bank that sprays its indorsement onto a check may wish to include this information in its indorsement to limit the number of locations at which it must accept returned checks. The Board therefore proposes to permit but not require the inclusion of the depository bank's name and location in its indorsement.

Appendix D currently does not contain any content requirements for returning bank indorsements and implicitly permits the indorsements to be placed on the front of the check. Under ANS X9.90, however, a returning bank that also is a reconverting bank with respect to a substitute check must be identified as such on the back of the check. The Board therefore proposes to amend appendix D to require returning bank indorsers to comply with the same indorsement requirements as collecting banks. Specifically, the Board proposes to require that a subsequent collecting bank or returning bank indorsement be applied to the back of a check and include only (1) the bank's nine-digit routing number, and, if the returning bank is a reconverting bank with respect to the check, an asterisk at each end of the number to identify the bank as a reconverting bank, (2) the indorsement date, and (3) an optional trace or sequence number. The Board requests comment on what benefits, if any, there would be in providing returning banks with the flexibility to indorse on the front of checks and to include additional information in their indorsements.

The Board notes that Regulation CC does not require paying banks to indorse checks. To facilitate compliance with section 4 of the Check 21 Act, however, a paying bank that also is a reconverting bank with respect to a substitute check should be identified as such on the check in a manner that a subsequent reconverting bank can preserve.<sup>14</sup> The Board therefore proposes to amend appendix D to require a paying bank that is also a reconverting bank with respect to a substitute check to identify itself as such by placing on the back of the check its nine-digit routing number (without arrows) and an asterisk at each end of the number. This identification would not constitute an indorsement.

Finally, for purposes of clarity, the Board proposes other technical amendments to appendix D.

The Board requests comment on all aspects of the proposed indorsement and identification standards discussed above.

---

<sup>14</sup> If the paying bank were a reconverting bank and did not identify itself as such on the back of the check, then the only place the paying bank would be identified as a reconverting bank would be the routing number of the paying bank, surrounded by asterisks, on the front of the check (according to ANS X9.90). If the substitute check were subsequently converted to electronic form and reconverted to paper, the identification of the paying bank as a reconverting bank on the front of the check would be lost, because its routing number would be replaced with the identification of the subsequent reconverting bank. This would place the subsequent reconverting bank in violation of the Check 21 Act's requirement "to preserve any previous reconverting bank identifications" (see section 4(d) of the Check 21 Act).

E. Section 229.51 General Provisions Governing Substitute Checks.

1. Legal Equivalence and Agreement.

Section 4(b) of the Check 21 Act provides that a substitute check is the legal equivalent of the original check for all purposes and all persons if the check contains an accurate image of the front and back of the original check and bears a specified "legal equivalence" legend. Although section 4(b) does not mention warranties as a precondition of legal equivalence, section 4(a) provides that any person may deposit, present, collect, or return a substitute check without the agreement of the recipient so long as a bank has made the substitute check warranties with respect to that check. Section 4(a) clearly intends that persons are required to accept a substitute check without agreement only if a bank has provided the substitute check warranties. The Board therefore believes that section 4(a) in effect requires a bank warranty as another prerequisite of legal equivalence. Section 229.51(a) of the proposed rule would make this requirement explicit by providing that a substitute check for which a bank has provided the substitute check warranties is the legal equivalent of the original check for all purposes and all persons if it meets the accuracy and legend requirements.

The proposed commentary to § 229.51(a) reiterates that a substitute check created by a person other than a bank can be transferred only by agreement unless and until a bank makes the substitute check warranties with respect to that check. The proposed commentary clarifies that a substitute check created by a person who is not a bank therefore cannot be the legal equivalent of the original check absent a bank's agreement to make the substitute check warranties. The commentary also provides clarification about what information on the check must be accurately represented as a prerequisite for legal equivalence. Finally, the commentary to § 229.52(b)(2) states that the legal equivalence legend must use the language specified in that section.

2. Reconverting Bank Duties.

Proposed § 229.51(b)(1)-(2) contains the reconverting bank duties described in sections 4(c) and 4(d) of the Check 21 Act regarding indorsements and identifications. In addition, § 229.51(b)(3) requires a reconverting bank to identify the bank that truncated the original check. The Board proposes to impose this requirement by regulation because ANS X9.90 requires identification of the truncating bank and because it is likely that banks in the collection and return chain would want to identify the truncating bank if there were a problem with a substitute check because the truncating bank would be in the best position to provide the original check or additional information about the original check. The proposed regulation requires the reconverting bank and truncating bank identifications to be applied in accordance with generally applicable industry standards and with appendix D of Regulation CC.

The proposed commentary to § 229.51 provides that, although a reconverting bank is responsible for preserving all previously-applied indorsements, it is not responsible for obtaining indorsements that should have been applied but were not. The

proposed commentary also notes that some previously applied indorsements will be preserved because they will be shown on a substitute check's image of the back of the original check, whereas the reconverting bank must physically apply to the back of the substitute check any previous indorsements that were applied electronically. The proposed commentary also notes that, under appendix D, the reconverting bank indorsement and identification are set off with asterisks and the truncating bank identification is set off with brackets. The proposed commentary also makes clear that preservation of a previous reconverting bank's indorsement (or identification, if the reconverting is the paying bank) set off by asterisks on the back of the check also satisfies the requirement of preserving the previous reconverting bank's identification.

### 3. Legal Status of an Item That Purports to Be a Substitute Check but Is Not.

As described in the discussion above concerning the definition of a substitute check, a reproduction of an original check that does not have the same MICR line as the original check would not be a substitute check. However, the Board believes that a bank that transfers such an item as if that item were a substitute check should not be allowed to evade the requirements of the Check 21 Act and subpart D simply because the item it created failed to meet the substitute check definition.<sup>15</sup> To protect recipients of such items and to provide incentives for reconverting banks to ensure that they only transfer items that comply with subpart D, the proposed rule provides that the recipient of an item that purports to be but is not a substitute check has warranty and indemnity rights, and, where applicable, recredit and consumer awareness disclosure rights under subpart D as though the item were a substitute check. The Board requests comment on whether an item that fails to meet any of the other the substitute check requirements in § 229.2(zz) also should be treated as though it were a substitute check for those limited purposes.

### 4. Applicable Law.

Proposed § 229.52(c) incorporates the Check 21 Act's provision stating that a substitute check that meets the legal equivalence requirements is subject to any existing federal or state law as though it were the original check, to the extent that such provision is not inconsistent with the Check 21 Act. The proposed commentary to this section clarifies that a law is not inconsistent with the Check 21 Act merely because it allows for the recovery of additional damages.

#### F. Section 229.52 Substitute Check Warranties.

Proposed § 229.52 of the rule implements section 5 of the Check 21 Act, which contains new warranties relating to substitute checks. For purposes of clarity, the proposed rule is organized differently than the Check 21 Act.

---

<sup>15</sup> An item could purport to be a substitute check, for example, if it contained the legal equivalence legend or if a person provided the item when applicable law required production of the original check.

1. Content and Provision of the Substitute Check Warranties.

Proposed § 229.52(a) sets forth the content of the substitute check warranties and identifies the banks that provide, and the events that trigger provision of, those warranties. The warranties are (1) that the substitute check meets the requirements for legal equivalence (i.e., that the substitute check accurately represents the information on the front and back of the original check and bears the legal equivalence legend) and (2) that no depository bank, drawee, drawer, or indorser will be asked to make payment based on a check that it already has paid.

In describing the second warranty, the Check 21 Act provides that none of the named parties will receive "presentment or return" of an item such that it will be asked to make a duplicative payment. However, one such recipient, the drawer, typically would not receive presentment or return of a check but rather would have its account charged for the check. The proposed rule therefore states that the named parties will not receive presentment or return of, or otherwise be charged for, a duplicative item.

The Check 21 Act states that each of the two warranties is made when a bank transfers, presents, or returns a "substitute check" for consideration. However, the list of warranty recipients, which includes persons that received some other paper or electronic form of the substitute check, indicates that banks continue to provide the warranties even if they transfer and receive consideration for something that is not, but that was derived from, a substitute check. Section 229.52(a) of the proposed rule therefore provides specifically that a bank makes the warranties when it transfers, presents, or returns for consideration the substitute check or any paper or electronic representation of a substitute check.

The Board notes that the Check 21 Act and the proposed rule state that the warranty against duplicative presentment or return applies such that the depository bank, drawee, drawer, or indorser will not receive presentment or return "of the substitute check, the original check, or a copy or other paper or electronic version of the substitute check or original check" such that that person "will be asked to make a payment based on a check" it already has paid. This language could be read to exclude a situation where a second charge results from an ACH debit that was created using information from an original check or substitute check.<sup>16</sup> However, such an ACH debit arguably could be considered "an electronic version" of a substitute check or original check to which the duplicative payment warranty would apply. The Board specifically requests comment on whether using information from a check to create an ACH debit entry should be a payment request covered by this warranty.

The proposed commentary to § 229.52(a) clarifies that the reconverting bank is the first bank to provide the substitute check warranties. That discussion also notes that,

---

<sup>16</sup> Such "check conversions" are covered under the Board's Regulation E and rules of the National ACH Association as electronic fund transfers rather than check transactions and are not, to the Board's knowledge, treated as check transactions for any other purpose.



when a bank is a reconverting bank because it by agreement receives a substitute check that a nonbank created, the reconverting bank starts the warranty chain for that substitute check even if the reconverting bank transfers an electronic representation of that substitute check instead of the actual substitute check that it received. The proposed commentary also clarifies that a bank that by agreement transfers an electronic version of an original check prior to the creation of the first substitute check does not make the substitute check warranties, but that parties to the agreement can allocate amongst themselves liabilities associated with the substitute check warranties. Moreover, the proposed commentary discusses the mechanics of each of the two warranties, including how they apply when multiple substitute checks are created with respect to the same payment transaction.

## 2. Warranty Recipients.

Section 5 of the Check 21 Act provides that warranties are provided to “the transferee, any subsequent collecting or returning bank, the drawee, the drawer, the payee, the depositor, and any endorser (regardless of whether the warrantee receives the substitute check or another paper or electronic form of the substitute check or original check) . . . .” Although § 229.52(b) of the proposed rule lists all these persons as warrantees, it does so in a slightly different manner than the statute. The warranties are intended to flow forward to all persons, including the paying bank, that received a substitute check or any paper or electronic representation of a substitute check, but not backward to persons that handled only the original check or some representation of the original check that was not derived from a substitute check. The rule therefore states that the warranties are provided to the recipient and any subsequent recipient, including all of the parties specifically listed in the statute, regardless of whether the recipient received the substitute check or another paper or electronic representation of the substitute check. The proposed commentary to § 229.52(b) provides additional discussion about the flow of the warranties.

## G. Section 229.53 Substitute Check Indemnity.

### 1. Scope of Indemnity.

Section 6 of the Check 21 Act specifies the scope and amount of the substitute check indemnity, and the proposed rule incorporates this section largely unchanged. The proposed rule states that a bank that transfers, presents, or returns a substitute check or a paper or electronic representation of a substitute check for which it receives consideration shall indemnify the recipient and any subsequent recipient (including a collecting or returning bank, the depositary bank, the drawer, the drawee, the payee, the depositor, and any indorser) for any loss incurred by any recipient of a substitute check if that loss occurred due to the receipt of a substitute check instead of the original check. As with the proposed rule’s language regarding the scope of the warranties, discussed in detail in the analysis of § 229.52, the proposed language regarding the scope of the substitute check indemnity clarifies that the indemnity flows to subsequent, not prior, parties that receive a substitute check or a representation of a substitute check.

The proposed commentary regarding the scope of the indemnity highlights that the indemnity applies only if the first indemnified party incurred a loss due to receipt of the substitute check instead of the original check. However, a bank that paid an indemnity (other than the first reconverting bank) would in turn be eligible to make an indemnity claim even if that bank only received a representation of a substitute check. Thus, the indemnity covers losses suffered directly due to the receipt of a substitute check instead of the original check and losses incurred by providing an indemnity to another person. The proposed commentary provides several examples to illustrate the scope of the indemnity.

## 2. Indemnity Amount.

The proposed rule incorporates the statutory language regarding the indemnity amount with minor clarifications. The rule provides that the amount of the indemnity is (1) the amount of any loss (including interest, costs, reasonable attorney's fees, and other expenses of representation) caused by the breach of a substitute check warranty, or (2) in the absence of a breach of a substitute check warranty, the amount of the loss, up to the amount of the substitute check, plus interest and expenses (including costs and reasonable attorney's fees and other expenses of representation). The proposed rule supplements the statutory language by specifically stating that interest would be included in the damages proximately caused by a breach of a substitute check warranty.

The proposed rule also incorporates statutory provisions regarding reduction of the indemnity amount. Section 229.53(b)(2) of the proposed rule states that the indemnity amount described in the preceding paragraph will be reduced in proportion to the amount of negligence or bad faith of the party making the indemnity claim, but that nothing in that comparative negligence section reduces any person's rights under the U.C.C. or other applicable law. Section 229.53(b)(3) of the proposed rule provides that an indemnifying bank will be liable only for losses incurred up to the time that it produces the original check or a sufficient copy of the original check, although production of that item does not absolve the indemnifying bank from liability for breaching a substitute check warranty or a warranty established under any other law.

The proposed commentary to § 229.53(b) provides examples that illustrate the amount of the indemnity under various sets of facts.

## 3. Subrogation of Rights.

Section 229.53(c) of the proposed rule incorporates section 6(e) of the statute by providing that an indemnifying bank shall be subrogated to the rights of the party it indemnified to the extent of the indemnity provided and may attempt to recover from another party based on a warranty or other claim. This section also provides that the indemnified party has a duty to comply with reasonable requests for assistance made by the indemnifying bank with respect to such a claim. The proposed commentary provides an example of what would constitute a reasonable request for assistance.

#### H. Section 229.54 Expedited Recredit for Consumers.

Section 7 of the statute sets forth the circumstances giving rise to a consumer expedited recredit claim, the time period and procedures for making such a claim, the conditions for a recredit, the timing and availability of a recredit, a bank's ability to reverse a recredit on a later determination that the consumer's claim was not valid, and the notices a bank must provide in connection with recredit claims. Section 229.54 of the proposed rule implements all of these provisions but reorganizes them for purposes of clarity. The Board also proposes to supplement the statutory text in certain respects in order to explicitly acknowledge certain actions that are implicit in the text of the statute.

##### 1. Circumstances Giving Rise to a Claim.

Section 229.54(a) of the proposed rule provides that a consumer may make an expedited recredit claim under that section for a recredit with respect to a substitute check if the consumer asserts in good faith that (1) the bank holding the consumer's account charged that account for a substitute check that was provided to the consumer (although the consumer need not be in possession of the substitute check at the time he or she submits a claim); (2) the substitute check was not properly charged to the consumer account or the consumer has a warranty claim with respect to the substitute check; (3) the consumer suffered a resulting loss; and (4) production of the original check or a sufficient copy of the original check is necessary to determine whether or not the substitute check in fact was improperly charged or whether the consumer's warranty claim is valid. This section implements sections 7(a)(1) and 7(h) of the Check 21 Act with some organizational changes.

The proposed commentary on the circumstances giving rise to a claim provides additional detail concerning when a consumer would and would not meet the criteria for bringing an expedited recredit claim under § 229.54. For example, the commentary clarifies that a consumer who receives only an image statement that contains an image of a substitute check cannot make a claim because he or she has not actually received a substitute check, although such a consumer would have redress for an improper charge associated with the substitute check under the U.C.C. and might have a claim for breach of a substitute check warranty. The commentary also notes that the warranty giving rise to a § 229.54 claim could be a substitute check warranty or any other warranty provided to the consumer in connection with the substitute check. The commentary further notes that recovery under § 229.54 is limited to the amount of the substitute check, plus interest if the consumer has an interest-bearing account, although a consumer may be able to recover additional amounts under other law, including §§ 229.52 and 229.53 of the proposed rule.

##### 2. Procedures for Making Claims.

a. *Timing of Claim.* The Check 21 Act states that a consumer's expedited recredit claim is due before the end of the 40-day period beginning on the later of the date that the bank mailed or delivered to the consumer the periodic account statement that

contains information about the transaction giving rise to the claim or the date on which the bank made the substitute check available to the consumer. Section 229.54(b)(1)(i) of the proposed rule implements this provision. The proposed rule clarifies that the 40-day time period refers to calendar days and that a bank makes a substitute check "available" by mailing or delivering it to the consumer.

The statute provides that the bank must extend the consumer's time for making a claim by a reasonable period of time if the consumer cannot meet the 40-day deadline due to extenuating circumstances, such as his or her extended travel or illness. Section 229.54(b)(1)(ii) of the proposed rule includes the general provision regarding the time extension but moves to the commentary the specific examples of what constitutes an extenuating circumstance. This parallels the approach the Board took when implementing the Electronic Fund Transfer Act (see 15 U.S.C. 1693(g) and 12 CFR § 205.6(b)(4)).

b. *Content of Claim.* Section 229.54(b)(2) of the proposed rule states that the consumer's claim must include (1) a description of the consumer's claim, including the reason why the consumer believes his or her account was improperly charged for the substitute check or the nature of his or her warranty claim with respect to such check; (2) a statement that the consumer suffered a loss and an estimate of the amount of that loss; (3) the reason why production of the original check or a sufficient copy of the original check is necessary to determine whether or not the charge to the consumer's account was proper or the consumer's warranty claim is valid; and (4) sufficient information to allow the bank to identify the substitute check and investigate the claim. The proposed rule uses the defined term "sufficient copy," as opposed to the Check 21 Act's "better copy," of the original check. As defined, a sufficient copy by its nature would be a better copy.

The proposed commentary to § 229.54(b)(2) discusses in more detail the reasons why a charge to the consumer's account could be improper and why the original check or a sufficient copy would be necessary to determine the validity of the consumer's recredit claim. The proposed commentary also discusses what types of information a consumer should provide to facilitate the bank's investigation of a claim.

c. *Form and Submission of Claim.* Section 229.54(b)(3) of the proposed rule incorporates the statutory provisions regarding the bank's ability to require a consumer to submit an expedited recredit claim in writing and the bank's ability to accept a written submission electronically. The proposed commentary to § 229.54(b)(3) clarifies that a bank that requires a claim to be in writing must inform the claimant of that requirement and also indicates that a communication, whether oral or written, that does not contain all the required information does not constitute a "claim" under § 229.54.

Although the statute states that a bank may permit an electronic submission "if the consumer has agreed to communicate with the bank in that manner," the proposed rule omits the quoted language. The Board believes that a consumer's act of submitting a claim electronically indicates the consumer's agreement to communicate electronically,

such that the statute's agreement language is unnecessary. However, the proposed commentary notes that a bank cannot require a consumer to submit a written claim electronically.

The proposed rule also clarifies that a bank that requires the consumer's claim to be in writing must compute the time period for acting on the claim from the date that the consumer submitted the written claim, even if the consumer previously provided some information relating to the claim in another form.<sup>17</sup> In addition, the statute measures time from the "business day" (defined as any day, other than a Saturday, Sunday, or legal holiday) on which the bank received a claim. However, the Board proposes to incorporate the term "banking day," as it has for other parts of Regulation CC. Banking day means "that part of any business day on which an office of a bank is open to the public for carrying on substantially all of its banking functions." The Board believes that "banking day" is an appropriate term when referring to the time at which a bank must begin measuring the time period for action. The Board requests comment on both of these adjustments relating to time period calculations.

### 3. Action on Claims.

Section 7(c)(1) of the Check 21 Act requires a bank that receives a complete and timely claim for which all the prerequisites are met to recredit the consumer's account for the amount of the substitute check, plus interest if the consumer's account is an interest bearing account, unless the bank has provided the original check or a sufficient copy to the consumer and demonstrated to the consumer that the substitute check was properly charged to his or her account. Section 7(c)(2) of the Check 21 Act requires the bank to provide the recredit no later than the end of the business day following the business day on which the bank determined that the consumer's claim was valid or, if the bank has not yet determined the validity of the claim, before the end of the 10<sup>th</sup> business day after the business day on which the consumer recredited the claim. Section 7(c)(2) limits the amount that the bank is required to provide on the 10<sup>th</sup> day to the amount of the loss, up to the lesser of the amount of the substitute check or \$2,500, plus interest, and requires the bank to provide the additional amount of the substitute check, if any, on the 45<sup>th</sup> calendar day following the business day on which the consumer submitted the claim. Section 7(e) of the Check 21 Act provides that a bank may reverse a recredit if it determines that the substitute check in question was properly charged to the consumer account and if it notifies the consumer.

The proposed rule incorporates each of the Check 21 Act's substantive requirements regarding action on a consumer's expedited recredit claim but reorganizes those requirements in a way that the Board believes is more straightforward. The Board requests comment on whether or not its proposed reorganization of the statutory provisions regarding action on claims is an improvement over the statutory organization and encourages commenters to provide specific organizational suggestions.

---

<sup>17</sup> The commentary to this provision clarifies that a bank that requires expedited recredit claims to be in writing must inform the consumer.

Section 229.54(c)(1) of the proposed rule provides that one of the bank's options for responding to a recredit claim is affirmatively to determine a consumer's claim to be valid. Although the statute does not list this possible response explicitly, the bank's ability to respond to a claim by determining that the claim is valid is implicit in the "timing of the recredit" section of the statute (section 7(c)(2)(A)), which requires the bank to provide a recredit the day after it determines that the consumer's claim is valid.

The statute provides that if a bank determines that the consumer's claim is not valid, the bank must provide the consumer with the original check or a copy of the original check sufficient to determine the validity of the claim and must demonstrate why the substitute check was properly charged to the consumer account. Because the statute provides that a warranty claim may be the basis of a consumer's expedited recredit claim, § 229.54(c)(2), by reference to § 229.54(e)(2), of the proposed rule requires the bank either to demonstrate that a charge was proper or to explain why the warranty claim is not valid, as appropriate in light of the consumer's claim.

Section 7(c) of the statute states that a bank must recredit the amount of the substitute check, plus interest if the account is an interest-bearing account. However, recrediting the full amount of the check could create overcompensation in some cases, such as where the consumer's allegation is that the bank charged the substitute check for the wrong amount. Section 229.54(c) of the proposed rule therefore provides that a bank must recredit the amount of the loss, up to the amount of the substitute check plus interest.

If, after providing a recredit, a bank later determines that the consumer's claim is not valid, § 229.54(c)(4) of the proposed rule would allow the bank to reverse both the amount it previously recredited plus any interest that it has paid on that amount. The statute does not explicitly address the reversal of interest when reversing a recredit, and the Board specifically requests comment on whether the proposed approach is appropriate.

The proposed commentary to § 229.54(c) clarifies that a bank that receives claims for multiple substitute checks in the same communication must provide the expedited recredit for each such check by the 10<sup>th</sup> day after submission, unless the bank by that date has determined whether or not the claims are valid. The commentary also clarifies that a bank may, when appropriate, reverse any amount that it previously recredited, regardless of whether such amount originally was provided after a determination that a claim was valid or pending the bank's investigation of the claim. The Board requests comment on whether additional commentary to § 229.54 would be useful and, if so, what specific points should be covered.

#### 4. Availability of recredit.

Section 7(d) of the statute provides that a bank can delay the availability of a recredit if the account is a new account or has been repeatedly overdrawn in the last six months, or if the bank has reasonable cause to suspect fraud. The proposed rule

incorporates the statutory language with minor clarifications. The statute states that the new account exception applies if "the claim is made" within 30 days of establishment of the account, whereas the proposed rule provides that the exception applies if "the consumer submits the claim" within 30 days. This change clarifies when a claim "is made" in a manner that is consistent with the other time period calculations in the statute and proposed rule. The rule also reorganizes the language in the exception for prevention of fraud losses to parallel the existing exception for reasonable cause to doubt collectibility in § 229.13.

The proposed commentary to § 229.54(d) clarifies that the availability of recredits provided under § 229.54(c) is governed solely by § 229.54(d) and thus is not subject to subpart B. The commentary also clarifies that the periods in § 229.54(d) are the maximum periods that the bank may delay availability. In addition, the commentary clarifies that the bank may delay availability of a recredit under § 229.54(d) only with respect to the amount of the substitute check that the bank recredits under § 229.54(c)(3)(i) pending investigation of the consumer's claim.

#### 5. Notices Relating to Consumer Expedited Recredit Claims.

Section 229.54(e) of the proposed rule describes the notices required by the statute when a bank provides or reverses a recredit or denies a consumer's recredit claim. The proposed rule provides that a bank that recredits a consumer account must, no later than the business day after the banking day on which the bank provides the recredit, notify the consumer of the amount of the recredit and the date on which the recredited funds will be available for withdrawal.

The proposed rule requires a bank that determines that a consumer's claim is not valid to notify the consumer no later than the business day after the banking day on which the bank makes its determination. The proposed rule provides that an invalid claim notice must include an explanation of the basis for the bank's determination that the substitute check was properly charged or the consumer's warranty claim is not valid, plus the original check or a sufficient copy of the original check. The statute requires a bank that denies a consumer's expedited recredit claim to notify the consumer that he or she may request the information or documents on which the bank relied in making its determination. However, the proposed rule allows a bank that relies on information or documents in addition to the original check or sufficient copy to provide such information or documents with the notice or to indicate that the consumer may obtain them on request.

The proposed rule provides that a bank that reverses an amount it previously credited to a consumer account must notify the consumer no later than the business day after the banking day on which the bank made the reversal. This notice must include the information required for an invalid claim notice, plus the amount of the reversal, including both the amount of the recredit and the amount of paid interest, if any, being reversed, and the date on which the bank made the reversal.

The proposed commentary to § 229.54(e) clarifies that a bank may provide a required notice by U.S. mail or by any other means through which the consumer has agreed to receive account information. The commentary highlights that, if a bank is required to provide an original check or sufficient copy as part of the notice, a bank that provides a notice electronically satisfies that requirement by providing an electronic image of the original check or sufficient copy, if the consumer has agreed to receive that information electronically.

As discussed in the analysis of appendix C, the Board proposes model language for each of the notices required by § 229.54(e).

#### I. Section 229.55 Expedited Recredit for Banks.

Section 8 of the Check 21 Act provides that a bank may make a claim against an indemnifying bank if (1) the claimant bank or a bank that the claimant bank has indemnified has received a claim for expedited recredit from a consumer or would have been subject to such a claim if the consumer account had been charged for the substitute check; (2) the claimant bank is obligated to provide a consumer expedited recredit with respect to such substitute check or otherwise has suffered a resulting loss; and (3) the production of the original check or a sufficient copy of the original check is necessary to determine the validity of the charge to the consumer account or the validity of any warranty claim connected with such substitute check. The content requirements for an interbank expedited recredit claim essentially parallel those for a consumer expedited recredit claim but also state that a bank that provides a copy of a substitute check with its claim must take steps to ensure that such copy is not mistaken for a legally equivalent substitute check or handled for forward collection or return. An indemnifying bank may require the claim to be in writing and may permit the claimant bank to submit it electronically.

A claimant bank must bring its claim under section 8 of the Check 21 Act within 120 days of the transaction that gave rise to the claim, and the indemnifying bank must respond within 10 business days of receiving the claim by providing (1) a recredit, (2) the original check or a sufficient copy, (3) or information to the claimant bank as to why the indemnifying bank is not obligated to do (1) or (2). If the claimant bank later receives or reverses a recredit or otherwise receives compensation for the substitute check for which the indemnifying bank previously provided a recredit, then the claimant bank must reimburse the indemnifying bank. An indemnifying bank that provides an original check or sufficient copy also may be entitled to a refund under § 229.53 if it has provided a recredit that exceeds the losses the claimant bank sustained up to the day that the indemnifying bank provided the original check or sufficient copy.

The proposed rule implements section 8 of the statute with some minor organizational and clarifying changes. The rule clarifies that bank action on a claim is required by "the end of" the 10<sup>th</sup> business day after the relevant banking day, consistent with the parallel consumer recredit provision. Moreover, the proposed rule clarifies that,



when an indemnifying bank requires a claim to be in writing, the 10-day period commences with the receipt of the written claim.

The proposed rule also clarifies both paragraphs of the Check 21 Act regarding the indemnifying bank's right to a refund. Section 7(c)(3) of the statute states that the "claimant bank must refund . . . any amount previously advanced by the indemnifying bank." Without further elaboration, this provision could be read to mean that a claimant bank must give to the indemnifying bank more than the claimant bank recovered.<sup>18</sup> The rule makes clear that a claimant bank that receives other compensation for the substitute check does not have to refund to the indemnifying bank more than the claimant bank previously recovered from the indemnifying bank. In addition, section 8(d) of the statute provides that an indemnifying bank that produces the original check or a sufficient copy has the right to a refund under the indemnity section. Section 229.55(e)(2) of the proposed rule clarifies the statutory language by describing the amount to be refunded under that provision.

The proposed commentary to § 229.55 elaborates on the rule text in several respects. The commentary highlights that a bank could have a recredit claim either because it is obligated to provide a recredit to a consumer or another bank or because it has suffered a loss as result of catching a substitute check problem that, if uncaught, could have given rise to a consumer expedited recredit claim. The commentary provides examples about the types of losses that could give rise to consumer claim and the circumstances under which a bank could bring a valid claim. The commentary also provides additional information relating to the procedures for making claims.

#### J. Section 229.56 Liability.

The Check 21 Act provides for delays in an emergency in section 9, the measure of damages in section 10, and the statute of limitations and notice of claims in section 11. Section 229.56 of the proposed rule incorporates each of those sections with minor technical changes in a manner that parallels existing subpart C liability provisions in § 229.38.

Section 229.56 (a) of the proposed rule provides that the amount of damages recoverable for a breach of a substitute check warranty or failure to comply with any provision of subpart D generally is limited to the amount of the loss or the substitute check, whichever is less, plus interest and expenses relating to the substitute check. This section contains exceptions, however, noting that a person could recover more than the generally applicable amount by bringing an indemnity claim or could recover less than the generally applicable amount if the person's negligence or bad faith contributed to the loss or if the person obtained a recredit under § 229.54 or § 229.55.

---

<sup>18</sup> For example, if the claimant bank received a recredit for \$150 and then received a subsequent recovery for \$100, the refund to the indemnifying bank should be the amount of the recovery (\$100) rather than the entire amount previously advanced (\$150).

Section 229.56(b) of the proposed rule states that delay by a bank beyond the time periods described in subpart D is excused if such delay is attributable to one of the causes specified in that paragraph.

Section 229.56(c) of the proposed rule specifies the courts in which a person may bring an action to enforce subpart D and provides that such an action must be brought within one year after the cause of action accrues. The statute provides that a cause of action accrues as of the date the injured party first learns or reasonably should have learned of the facts and circumstances giving rise to the cause of action. The proposed rule clarifies that one of the facts and circumstances included in the concept of accrual is the identity of the bank against which the action is to be brought. This clarification is intended to make the date from which the statute of limitations is measured correspond to the date from which timely notice of a claim is measured.

Section 229.56(d) generally provides that, unless a person gives notice of a § 229.56 claim to the warranting or indemnifying bank within 30 calendar days after the person has reason to know of both the claim and the identity of the indemnifying or warranting bank, the warranting or indemnifying bank is discharged from liability in an action to enforce a claim under subpart D to the extent of any loss caused by the delay in giving notice of the claim. However, this paragraph also states that a timely recredit claim by a consumer under § 229.54 constitutes timely notice under this paragraph.

The proposed commentary to § 229.54 briefly elaborates on each of the four paragraphs of that section in a manner that corresponds to the commentary for § 229.38.

#### K. Section 229.57 Consumer Awareness.

This section of the proposed rule implements section 12 of the Check 21 Act, which requires a bank to provide a consumer awareness disclosure regarding substitute checks and substitute check rights to each consumer "who receives original checks or substitute checks." The Board believes that the quoted language, when read with the statutory provisions governing distribution of notices, indicates that section 12 disclosures are intended only for (1) consumers who routinely receive paid checks with their account statements and (2) other consumers who receive substitute checks only on a case-by-case basis. The proposed rule reflects this interpretation.

The proposed rule specifically notes that, unless the bank already has provided the disclosure, a case-by-case disclosure is required when (1) a consumer receives a substitute check in response to his or her specific request for an original check or a copy of a check or (2) a check deposited by a consumer is returned unpaid to the consumer's account in the form of a substitute check. The Check 21 Act requires that when a bank provides a substitute check to a consumer in response to the consumer's request for a check, the bank must provide the consumer disclosure at the time of the request. This requirement may be impractical, however, as the bank may not know at the time of the request whether it will provide the original check, a substitute check, or some other copy of the check. Requiring the bank to provide the disclosure at the time of the request

could prove unnecessarily burdensome to the bank and confusing to the consumer, because the consumer would receive a disclosure describing rights that may not apply to the item the consumer ultimately receives. The Board therefore has proposed two alternative rule provisions regarding when a bank must provide the disclosure to a consumer who requests a copy of a check. One alternative tracks the statute and requires a bank to provide the disclosure at the time of the request, but the other alternative requires provision of the disclosure at the time the bank provides the substitute check to the consumer. The Board specifically requests comment on which of these alternatives is preferable.

The proposed commentary to § 229.57 indicates that a bank may use the model substitute check disclosure in appendix C and will be deemed to comply with the disclosure content requirement(s) for which it uses the model disclosure. The commentary also provides examples of when a bank must distribute the required disclosure.

L. Section 229.58 Mode of Delivery.

The Check 21 Act discusses in several places the form in which a bank must provide required information. The proposed rule, by contrast, has a separate section regarding mode of delivery that applies to the entire subpart. Section 229.58 provides that a bank may provide any information required by subpart D by U.S. mail or by any other means through which the recipient has agreed to receive account information. This section also specifically allows a bank that is required to provide an original check or a sufficient copy to provide an electronic version of the relevant paper document if the recipient has agreed to receive that information electronically. This latter provision addresses the potential inconsistency between section 7(f)(2) as interpreted at § 229.54(e)(2), which requires a bank denying a consumer's recredit claim to provide the original check or a sufficient copy (each of which is by definition a piece of paper), with section 7(f)(4), which permits a bank to provide the notices (which presumably means all components of the notice) electronically.

M. Section 229.59 Relation to Other Law.

This section of the proposed rule implements section 13 of the Check 21 Act by stating that the Check 21 Act and subpart D supersede any provision of federal or state law, including the U.C.C., that is inconsistent with the Check 21 Act or subpart D, but only to the extent of the inconsistency.

N. Section 229.60 Variation by Agreement.

Section 229.60 of the proposed rule implements section 14 of the Check 21 Act by providing that any provision of § 229.55 (expedited recredit for banks) may be varied by agreement of the banks involved, but that no other provision of subpart D may be varied by agreement by any person or persons.

## O. Appendix C – Model Forms.

Section 12(c) of the Check 21 Act requires the Board to publish model forms that banks can use to satisfy the content requirements of the consumer awareness disclosure required by that section. Section 229.57 of the proposed rule lists those content requirements. The statute provides that a bank that uses the model form published by the Board to comply with § 229.57 shall be treated as complying with that section if the form accurately describes the bank's policies and practices.

The Board proposes to include the required model disclosure as model C-5A in appendix C. The proposed model disclosure explains in very simple terms what a substitute check is, when the consumer expedited recredit right applies, and what a consumer must do to exercise that right. The Board requests comment on whether the proposed model disclosure is clear, accurate, and concise.

Although not required by statute to do so, the Board also proposes to publish in appendix C models for the notices a bank must provide in response to a consumer's expedited recredit claim under section 7(f) of the Check 21 Act and § 229.54(e) of the proposed rule. Although there is no statutory safe harbor that applies to the proposed model notices under § 229.54(e), the Board nevertheless believes that these model notices may be helpful to banks in complying with the regulation. In light of the absence of a statutory safe harbor, the Board specifically requests comment on whether providing model language for the § 229.54(e) notices is useful.

The Board proposes technical amendments to the introductory paragraph and table of contents of appendix C to reflect the inclusion of the new disclosure and notices. The Board also proposes to amend the commentary to appendix C to clarify the appropriate use of the new models.

## II. *Other Amendments to Regulation CC*

The Board also is proposing at this time several amendments to existing Regulation CC and its commentary that are unrelated to the Check 21 Act. The Board requests comment on each of these proposed revisions and also welcomes comments about any other areas of the existing rule and commentary that should be clarified.

### A. Section 229.2 Definitions.

The Board proposes to amend the commentary to the definition of local paying bank (§ 229.2(s)) to provide additional detail regarding how to determine whether deposits mailed to a central check processing facility are local or nonlocal.

108TH CONGRESS }  
1st Session } HOUSE OF REPRESENTATIVES { REPORT  
108-291

## CHECK CLEARING FOR THE 21ST CENTURY ACT

OCTOBER 1, 2003 —Ordered to be printed

Mr OXLEY, from the committee of conference,  
submitted the following

### CONFERENCE REPORT

[To accompany H R 1474]

The committee of conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H R 1474), to facilitate check truncation by authorizing substitute checks, to foster innovation in the check collection system without mandating receipt of checks in electronic form, and to improve the overall efficiency of the Nation's payments system, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows

That the House recede from its disagreement to the amendment of the Senate and agree to the same with an amendment as follows

In lieu of the matter proposed to be inserted by the Senate amendment, insert the following

#### SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) **SHORT TITLE**—This Act may be cited as the "Check Clearing for the 21st Century Act" or the "Check 21 Act"

(b) **TABLE OF CONTENTS**—The table of contents of this Act is as follows:

- Sec 1 Short title, table of contents
- Sec 2 Findings, purposes
- Sec 3 Definitions
- Sec 4 General provisions governing substitute checks
- Sec 5 Substitute check warranties
- Sec 6 Indemnity
- Sec 7 Expedited recredit for consumers
- Sec 8 Expedited recredit procedures for banks
- Sec 9 Delays in an emergency
- Sec 10 Measure of damages
- Sec 11 Statute of limitations and notice of claim
- Sec 12 Consumer awareness
- Sec 13 Effect on other law

29-006

- Sec 14 Variation by agreement
- Sec 15 Regulations
- Sec 16 Study and report on funds availability
- Sec 17 Statistical reporting of costs and revenues for transporting checks between Federal Reserve banks
- Sec 18 Evaluation and report by the Comptroller General
- Sec 19 Depository services efficiency and cost reduction
- Sec 20 Effective date

#### **SEC. 2 FINDINGS; PURPOSES.**

##### **(a) FINDINGS —**The Congress finds as follows:

(1) In the Expedited Funds Availability Act, enacted on August 10, 1987, the Congress directed the Board of Governors of the Federal Reserve System to consider establishing regulations requiring Federal reserve banks and depository institutions to provide for check truncation, in order to improve the check processing system

##### **(2) In that same Act, the Congress—**

(A) provided the Board of Governors of the Federal Reserve System with full authority to regulate all aspects of the payment system, including the receipt, payment, collection, and clearing of checks, and related functions of the payment system pertaining to checks; and

(B) directed that the exercise of such authority by the Board superseded any State law, including the Uniform Commercial Code, as in effect in any State

(3) Check truncation is no less desirable in 2003 for both financial service customers and the financial services industry, to reduce costs, improve efficiency in check collections, and expedite funds availability for customers than it was over 15 years ago when Congress first directed the Board to consider establishing such a process.

##### **(b) PURPOSES —**The purposes of this Act are as follows

(1) To facilitate check truncation by authorizing substitute checks

(2) To foster innovation in the check collection system without mandating receipt of checks in electronic form

(3) To improve the overall efficiency of the Nation's payments system

#### **SEC. 3. DEFINITIONS.**

For purposes of this Act, the following definitions shall apply.

(1) **ACCOUNT.**—The term "account" means a deposit account at a bank

(2) **BANK.**—The term "bank" means any person that is located in a State and engaged in the business of banking and includes—

(A) any depository institution (as defined in section 19(b)(1)(A) of the Federal Reserve Act);

(B) any Federal reserve bank;

(C) any Federal home loan bank, or

(D) to the extent it acts as a payor—

(i) the Treasury of the United States,

(ii) the United States Postal Service;

(iii) a State government, or

(iv) a unit of general local government (as defined in section 602(24) of the Expedited Funds Availability Act)

**(3) BANKING TERMS —**

**(A) COLLECTING BANK**—The term "collecting bank" means any bank handling a check for collection except the paying bank

**(B) DEPOSITARY BANK**—The term "depository bank" means—

(i) the first bank to which a check is transferred, even if such bank is also the paying bank or the payee, or

(ii) a bank to which a check is transferred for deposit in an account at such bank, even if the check is physically received and indorsed first by another bank

**(C) PAYING BANK**—The term "paying bank" means—

(i) the bank by which a check is payable, unless the check is payable at or through another bank and is sent to the other bank for payment or collection, or

(ii) the bank at or through which a check is payable and to which the check is sent for payment or collection

**(D) RETURNING BANK.**—

(i) **IN GENERAL**—The term "returning bank" means a bank (other than the paying or depository bank) handling a returned check or notice in lieu of return

(ii) **TREATMENT AS COLLECTING BANK**—No provision of this Act shall be construed as affecting the treatment of a returning bank as a collecting bank for purposes of section 4-202(b) of the Uniform Commercial Code

**(4) BOARD**—The term "Board" means the Board of Governors of the Federal Reserve System

**(5) BUSINESS DAY**—The term "business day" has the same meaning as in section 602(3) of the Expedited Funds Availability Act.

**(6) CHECK**—The term "check"—

(A) means a draft, payable on demand and drawn on or payable through or at an office of a bank, whether or not negotiable, that is handled for forward collection or return, including a substitute check and a travelers check, and

(B) does not include a noncash item or an item payable in a medium other than United States dollars

**(7) CONSUMER**—The term "consumer" means an individual who—

(A) with respect to a check handled for forward collection, draws the check on a consumer account, or

(B) with respect to a check handled for return, deposits the check into, or cashes the check against, a consumer account

**(8) CONSUMER ACCOUNT**—The term "consumer account" has the same meaning as in section 602(10) of the Expedited Funds Availability Act

**(9) CUSTOMER**—The term "customer" means a person having an account with a bank

**(10) FORWARD COLLECTION**—The term "forward collection" means the transfer by a bank of a check to a collecting bank for settlement or the paying bank for payment

(11) **INDEMNIFYING BANK**—The term "indemnifying bank" means a bank that is providing an indemnity under section 6 with respect to a substitute check

(12) **MICR LINE**—The terms "MICR line" and "magnetic ink character recognition line" mean the numbers, which may include the bank routing number, account number, check number, check amount, and other information, that are printed near the bottom of a check in magnetic ink in accordance with generally applicable industry standards

(13) **NONCASH ITEM**—The term "noncash item" has the same meaning as in section 602(14) of the Expedited Funds Availability Act

(14) **PERSON**—The term "person" means a natural person, corporation, unincorporated company, partnership, government unit or instrumentality, trust, or any other entity or organization

(15) **RECONVERTING BANK**—The term "reconverting bank" means—

(A) the bank that creates a substitute check; or

(B) if a substitute check is created by a person other than a bank, the first bank that transfers or presents such substitute check

(16) **SUBSTITUTE CHECK**—The term "substitute check" means a paper reproduction of the original check that—

(A) contains an image of the front and back of the original check;

(B) bears a MICR line containing all the information appearing on the MICR line of the original check, except as provided under generally applicable industry standards for substitute checks to facilitate the processing of substitute checks;

(C) conforms, in paper stock, dimension, and otherwise, with generally applicable industry standards for substitute checks, and

(D) is suitable for automated processing in the same manner as the original check.

(17) **STATE**—The term "State" has the same meaning as in section 3(a) of the Federal Deposit Insurance Act

(18) **TRUNCATE**—The term "truncate" means to remove an original paper check from the check collection or return process and send to a recipient, in lieu of such original paper check, a substitute check or, by agreement, information relating to the original check (including data taken from the MICR line of the original check or an electronic image of the original check), whether with or without subsequent delivery of the original paper check

(19) **UNIFORM COMMERCIAL CODE**—The term "Uniform Commercial Code" means the Uniform Commercial Code in effect in a State.

(20) **OTHER TERMS**—Unless the context requires otherwise, the terms not defined in this section shall have the same meanings as in the Uniform Commercial Code

#### **SEC. 4. GENERAL PROVISIONS GOVERNING SUBSTITUTE CHECKS.**

(a) **NO AGREEMENT REQUIRED**—A person may deposit, present, or send for collection or return a substitute check without an agree-



ment with the recipient, so long as a bank has made the warranties in section 5 with respect to such substitute check.

(b) **LEGAL EQUIVALENCE.**—A substitute check shall be the legal equivalent of the original check for all purposes, including any provision of any Federal or State law, and for all persons if the substitute check—

(1) accurately represents all of the information on the front and back of the original check as of the time the original check was truncated; and

(2) bears the legend "This is a legal copy of your check. You can use it the same way you would use the original check."

(c) **ENDORSEMENTS.**—A bank shall ensure that the substitute check for which the bank is the reconverting bank bears all endorsements applied by parties that previously handled the check (whether in electronic form or in the form of the original paper check or a substitute check) for forward collection or return.

(d) **IDENTIFICATION OF RECONVERTING BANK.**—A bank shall identify itself as a reconverting bank on any substitute check for which the bank is a reconverting bank so as to preserve any previous reconverting bank identifications in conformance with generally applicable industry standards.

(e) **APPLICABLE LAW.**—A substitute check that is the legal equivalent of the original check under subsection (b) shall be subject to any provision, including any provision relating to the protection of customers, of part 229 of title 12 of the Code of Federal Regulations, the Uniform Commercial Code, and any other applicable Federal or State law as if such substitute check were the original check, to the extent such provision of law is not inconsistent with this Act.

#### **SEC. 5. SUBSTITUTE CHECK WARRANTIES.**

A bank that transfers, presents, or returns a substitute check and receives consideration for the check warrants, as a matter of law, to the transferee, any subsequent collecting or returning bank, the depository bank, the drawee, the drawer, the payee, the depositor, and any endorser (regardless of whether the warrantee receives the substitute check or another paper or electronic form of the substitute check or original check) that—

(1) the substitute check meets all the requirements for legal equivalence under section 4(b), and

(2) no depository bank, drawee, drawer, or endorser will receive presentment or return of the substitute check, the original check, or a copy or other paper or electronic version of the substitute check or original check such that the bank, drawee, drawer, or endorser will be asked to make a payment based on a check that the bank, drawee, drawer, or endorser has already paid.

#### **SEC. 6. INDEMNITY.**

(a) **INDEMNITY.**—A reconverting bank and each bank that subsequently transfers, presents, or returns a substitute check in any electronic or paper form, and receives consideration for such transfer, presentment, or return shall indemnify the transferee, any subsequent collecting or returning bank, the depository bank, the drawee, the drawer, the payee, the depositor, and any endorser, up to the amount described in subsections (b) and (c), as applicable, to the extent of any loss incurred by any recipient of a substitute check if

that loss occurred due to the receipt of a substitute check instead of the original check.

**(b) INDEMNITY AMOUNT —**

**(1) AMOUNT IN EVENT OF BREACH OF WARRANTY —**The amount of the indemnity under subsection (a) shall be the amount of any loss (including costs and reasonable attorney's fees and other expenses of representation) proximately caused by a breach of a warranty provided under section 5

**(2) AMOUNT IN ABSENCE OF BREACH OF WARRANTY —**In the absence of a breach of a warranty provided under section 5, the amount of the indemnity under subsection (a) shall be the sum of—

(A) the amount of any loss, up to the amount of the substitute check; and

(B) interest and expenses (including costs and reasonable attorney's fees and other expenses of representation)

**(c) COMPARATIVE NEGLIGENCE —**

**(1) IN GENERAL —**If a loss described in subsection (a) results in whole or in part from the negligence or failure to act in good faith on the part of an indemnified party, then that party's indemnification under this section shall be reduced in proportion to the amount of negligence or bad faith attributable to that party

**(2) RULE OF CONSTRUCTION —**Nothing in this subsection reduces the rights of a consumer or any other person under the Uniform Commercial Code or other applicable provision of Federal or State law.

**(d) EFFECT OF PRODUCING ORIGINAL CHECK OR COPY —**

**(1) IN GENERAL —**If the indemnifying bank produces the original check or a copy of the original check (including an image or a substitute check) that accurately represents all of the information on the front and back of the original check (as of the time the original check was truncated) or is otherwise sufficient to determine whether or not a claim is valid, the indemnifying bank shall—

(A) be liable under this section only for losses covered by the indemnity that are incurred up to the time that the original check or copy is provided to the indemnified party, and

(B) have a right to the return of any funds it has paid under the indemnity in excess of those losses

**(2) COORDINATION OF INDEMNITY WITH IMPLIED WARRANTY. —**The production of the original check, a substitute check, or a copy under paragraph (1) by an indemnifying bank shall not absolve the bank from any liability on a warranty established under this Act or any other provision of law

**(e) SUBROGATION OF RIGHTS —**

**(1) IN GENERAL. —**Each indemnifying bank shall be subrogated to the rights of any indemnified party to the extent of the indemnity

**(2) RECOVERY UNDER WARRANTY. —**A bank that indemnifies a party under this section may attempt to recover from another party based on a warranty or other claim.

**(3) DUTY OF INDEMNIFIED PARTY. —**Each indemnified party shall have a duty to comply with all reasonable requests for as-

sistance from an indemnifying bank in connection with any claim the indemnifying bank brings against a warrantor or other party related to a check that forms the basis for the indemnification

#### **SEC. 7. EXPEDITED RECREDIT FOR CONSUMERS.**

##### **(a) RECREDIT CLAIMS —**

(1) **IN GENERAL** —A consumer may make a claim for expedited recredit from the bank that holds the account of the consumer with respect to a substitute check, if the consumer asserts in good faith that—

(A) the bank charged the consumer's account for a substitute check that was provided to the consumer,

(B) either—

(i) the check was not properly charged to the consumer's account, or

(ii) the consumer has a warranty claim with respect to such substitute check,

(C) the consumer suffered a resulting loss, and

(D) the production of the original check or a better copy of the original check is necessary to determine the validity of any claim described in subparagraph (B)

(2) **40-DAY PERIOD**.—Any claim under paragraph (1) with respect to a consumer account may be submitted by a consumer before the end of the 40-day period beginning on the later of—

(A) the date on which the financial institution mails or delivers, by a means agreed to by the consumer, the periodic statement of account for such account which contains information concerning the transaction giving rise to the claim, or

(B) the date on which the substitute check is made available to the consumer

(3) **EXTENSION UNDER EXTENUATING CIRCUMSTANCES** —If the ability of the consumer to submit the claim within the 40-day period under paragraph (2) is delayed due to extenuating circumstances, including extended travel or the illness of the consumer, the 40-day period shall be extended by a reasonable amount of time

##### **(b) PROCEDURES FOR CLAIMS. —**

(1) **IN GENERAL** —To make a claim for an expedited recredit under subsection (a) with respect to a substitute check, the consumer shall provide to the bank that holds the account of such consumer—

(A) a description of the claim, including an explanation of—

(i) why the substitute check was not properly charged to the consumer's account; or

(ii) the warranty claim with respect to such check,

(B) a statement that the consumer suffered a loss and an estimate of the amount of the loss;

(C) the reason why production of the original check or a better copy of the original check is necessary to determine the validity of the charge to the consumer's account or the warranty claim, and

(D) sufficient information to identify the substitute check and to investigate the claim.

**(2) CLAIM IN WRITING —**

**(A) IN GENERAL —**The bank holding the consumer account that is the subject of a claim by the consumer under subsection (a) may, in the discretion of the bank, require the consumer to submit the information required under paragraph (1) in writing

**(B) MEANS OF SUBMISSION —**A bank that requires a submission of information under subparagraph (A) may permit the consumer to make the submission electronically, if the consumer has agreed to communicate with the bank in that manner.

**(c) RECREDIT TO CONSUMER —**

**(1) CONDITIONS FOR RECREDIT —**The bank shall recredit a consumer account in accordance with paragraph (2) for the amount of a substitute check that was charged against the consumer account if—

**(A)** a consumer submits a claim to the bank with respect to that substitute check that meets the requirement of subsection (b); and

**(B)** the bank has not—

**(i)** provided to the consumer—

**(I)** the original check; or

**(II)** a copy of the original check (including an image or a substitute check) that accurately represents all of the information on the front and back of the original check, as of the time at which the original check was truncated, and

**(ii)** demonstrated to the consumer that the substitute check was properly charged to the consumer account

**(2) TIMING OF RECREDIT —**

**(A) IN GENERAL —**The bank shall recredit the consumer's account for the amount described in paragraph (1) no later than the end of the business day following the business day on which the bank determines the consumer's claim is valid.

**(B) RECREDIT PENDING INVESTIGATION —**If the bank has not yet determined that the consumer's claim is valid before the end of the 10th business day after the business day on which the consumer submitted the claim, the bank shall recredit the consumer's account for—

**(i)** the lesser of the amount of the substitute check that was charged against the consumer account, or \$2,500, together with interest if the account is an interest-bearing account, no later than the end of such 10th business day, and

**(ii)** the remaining amount of the substitute check that was charged against the consumer account, if any, together with interest if the account is an interest-bearing account, not later than the 45th calendar day following the business day on which the consumer submits the claim

**(d) AVAILABILITY OF RECREDIT —**

**(1) NEXT BUSINESS DAY AVAILABILITY —**Except as provided in paragraph (2), a bank that provides a recredit to a consumer

account under subsection (c) shall make the recredited funds available for withdrawal by the consumer by the start of the next business day after the business day on which the bank recredits the consumer's account under subsection (c)

(2) **SAFEGUARD EXCEPTIONS**—A bank may delay availability to a consumer of a recredit provided under subsection (c)(2)(B)(i) until the start of either the business day following the business day on which the bank determines that the consumer's claim is valid or the 45th calendar day following the business day on which the consumer submits a claim for such recredit in accordance with subsection (b), whichever is earlier, in any of the following circumstances

(A) **NEW ACCOUNTS**.—The claim is made during the 30-day period beginning on the business day the consumer account was established

(B) **REPEATED OVERDRAFTS**—Without regard to the charge that is the subject of the claim for which the recredit was made—

(i) on 6 or more business days during the 6-month period ending on the date on which the consumer submits the claim, the balance in the consumer account was negative or would have become negative if checks or other charges to the account had been paid, or

(ii) on 2 or more business days during such 6-month period, the balance in the consumer account was negative or would have become negative in the amount of \$5,000 or more if checks or other charges to the account had been paid

(C) **PREVENTION OF FRAUD LOSSES**—The bank has reasonable cause to believe that the claim is fraudulent, based on facts (other than the fact that the check in question or the consumer is of a particular class) that would cause a well-grounded belief in the mind of a reasonable person that the claim is fraudulent.

(3) **OVERDRAFT FEES**—No bank that, in accordance with paragraph (2), delays the availability of a recredit under subsection (c) to any consumer account may impose any overdraft fees with respect to drafts drawn by the consumer on such recredited amount before the end of the 5-day period beginning on the date notice of the delay in the availability of such amount is sent by the bank to the consumer

(e) **REVERSAL OF RECREDIT**.—A bank may reverse a recredit to a consumer account if the bank—

(1) determines that a substitute check for which the bank recredited a consumer account under subsection (c) was in fact properly charged to the consumer account; and

(2) notifies the consumer in accordance with subsection (f)(3).

(f) **NOTICE TO CONSUMER** —

(1) **NOTICE IF CONSUMER CLAIM NOT VALID**—If a bank determines that a substitute check subject to the consumer's claim was in fact properly charged to the consumer's account, the bank shall send to the consumer, no later than the business day following the business day on which the bank makes a determination—

(A) the original check or a copy of the original check (including an image or a substitute check) that—

(i) accurately represents all of the information on the front and back of the original check (as of the time the original check was truncated), or

(ii) is otherwise sufficient to determine whether or not the consumer's claim is valid; and

(B) an explanation of the basis for the determination by the bank that the substitute check was properly charged, including a statement that the consumer may request copies of any information or documents on which the bank relied in making the determination.

(2) NOTICE OF RECREDIT.—If a bank recredits a consumer account under subsection (c), the bank shall send to the consumer, no later than the business day following the business day on which the bank makes the recredit, a notice of—

(A) the amount of the recredit; and

(B) the date the recredited funds will be available for withdrawal.

(3) NOTICE OF REVERSAL OF RECREDIT.—In addition to the notice required under paragraph (1), if a bank reverses a recredited amount under subsection (e), the bank shall send to the consumer, no later than the business day following the business day on which the bank reverses the recredit, a notice of—

(A) the amount of the reversal; and

(B) the date the recredit was reversed.

(4) MODE OF DELIVERY.—A notice described in this subsection shall be delivered by United States mail or by any other means through which the consumer has agreed to receive account information.

(g) OTHER CLAIMS NOT AFFECTED.—Providing a recredit in accordance with this section shall not absolve the bank from liability for a claim made under any other law, such as a claim for wrongful dishonor under the Uniform Commercial Code, or from liability for additional damages under section 6 or 10.

(h) CLARIFICATION CONCERNING CONSUMER POSSESSION.—A consumer who was provided a substitute check may make a claim for an expedited recredit under this section with regard to a transaction involving the substitute check whether or not the consumer is in possession of the substitute check.

(i) SCOPE OF APPLICATION.—This section shall only apply to customers who are consumers.

#### SEC. 8. EXPEDITED RECREDIT PROCEDURES FOR BANKS.

##### (a) RECREDIT CLAIMS —

(1) IN GENERAL.—A bank may make a claim against an indemnifying bank for expedited recredit for which that bank is indemnified if—

(A) the claimant bank (or a bank that the claimant bank has indemnified) has received a claim for expedited recredit from a consumer under section 7 with respect to a substitute check or would have been subject to such a claim had the consumer's account been charged,

(B) the claimant bank has suffered a resulting loss or is obligated to recredit a consumer account under section 7 with respect to such substitute check, and

## 11

(C) production of the original check, another substitute check, or a better copy of the original check is necessary to determine the validity of the charge to the customer account or any warranty claim connected with such substitute check

(2) 120-DAY PERIOD—Any claim under paragraph (1) may be submitted by the claimant bank to an indemnifying bank before the end of the 120-day beginning on the date of the transaction that gave rise to the claim

(b) PROCEDURES FOR CLAIMS—

(1) IN GENERAL—To make a claim under subsection (a) for an expedited recredit relating to a substitute check, the claimant bank shall send to the indemnifying bank—

(A) a description of—

(i) the claim, including an explanation of why the substitute check cannot be properly charged to the consumer account, or

(ii) the warranty claim,

(B) a statement that the claimant bank has suffered a loss or is obligated to recredit the consumer's account under section 7, together with an estimate of the amount of the loss or recredit,

(C) the reason why production of the original check, another substitute check, or a better copy of the original check is necessary to determine the validity of the charge to the consumer account or the warranty claim; and

(D) information sufficient for the indemnifying bank to identify the substitute check and to investigate the claim.

(2) REQUIREMENTS RELATING TO COPIES OF SUBSTITUTE CHECKS—If the information submitted by a claimant bank pursuant to paragraph (1) in connection with a claim for an expedited recredit includes a copy of any substitute check for which any such claim is made, the claimant bank shall take reasonable steps to ensure that any such copy cannot be—

(A) mistaken for the legal equivalent of the check under section 4(b), or

(B) sent or handled by any bank, including the indemnifying bank, as a forward collection or returned check

(3) CLAIM IN WRITING—

(A) IN GENERAL—An indemnifying bank may, in the discretion of the bank, require the claimant bank to submit the information required by paragraph (1) in writing, including a copy of the written or electronically submitted claim, if any, that the consumer provided in accordance with section 7(b)

(B) MEANS OF SUBMISSION—An indemnifying bank that requires a submission of information under subparagraph (A) may permit the claimant bank to make the submission electronically, if the claimant bank has agreed to communicate with the indemnifying bank in that manner

(c) RECREDIT BY INDEMNIFYING BANK—

(1) PROMPT ACTION REQUIRED.—No later than 10 business days after the business day on which an indemnifying bank receives a claim under subsection (a) from a claimant bank with respect to a substitute check, the indemnifying bank shall—

(A) provide, to the claimant bank, the original check (with respect to such substitute check) or a copy of the original check (including an image or a substitute check) that—

(i) accurately represents all of the information on the front and back of the original check (as of the time the original check was truncated), or

(ii) is otherwise sufficient to determine the bank's claim is not valid, and

(B) recredit the claimant bank for the amount of the claim up to the amount of the substitute check, plus interest if applicable, or

(C) provide information to the claimant bank as to why the indemnifying bank is not obligated to comply with subparagraph (A) or (B)

(2) **RECREDIT DOES NOT ABROGATE OTHER LIABILITIES** — Providing a recredit under this subsection to a claimant bank with respect to a substitute check shall not absolve the indemnifying bank from liability for claims brought under any other law or from additional damages under section 6 or 10 with respect to such check

(3) **REFUND TO INDEMNIFYING BANK**.—If a claimant bank reverses, in accordance with section 7(e), a recredit previously made to a consumer account under section 7(c), or otherwise receives a credit or recredit with regard to such substitute check, the claimant bank shall promptly refund to any indemnifying bank any amount previously advanced by the indemnifying bank in connection with such substitute check

(d) **PRODUCTION OF ORIGINAL CHECK OR A SUFFICIENT COPY GOVERNED BY SECTION 6(d)** —If the indemnifying bank provides the claimant bank with the original check or a copy of the original check (including an image or a substitute check) under subsection (c)(1)(A), section 6(d) shall govern any right of the indemnifying bank to any repayment of any funds the indemnifying bank has recredited to the claimant bank pursuant to subsection (c)

#### **SEC. 9. DELAYS IN AN EMERGENCY.**

A delay by a bank beyond the time limits prescribed or permitted by this Act shall be excused if the delay is caused by interruption of communication or computer facilities, suspension of payments by another bank, war, emergency conditions, failure of equipment, or other circumstances beyond the control of a bank and if the bank uses such diligence as the circumstances require

#### **SEC. 10. MEASURE OF DAMAGES.**

##### **(a) LIABILITY —**

(1) **IN GENERAL** —Except as provided in section 6, any person who, in connection with a substitute check, breaches any warranty under this Act or fails to comply with any requirement imposed by, or regulation prescribed pursuant to, this Act with respect to any other person shall be liable to such person in an amount equal to the sum of—

(A) the lesser of—

(i) the amount of the loss suffered by the other person as a result of the breach or failure, or

(ii) the amount of the substitute check, and



(B) interest and expenses (including costs and reasonable attorney's fees and other expenses of representation) related to the substitute check

(2) **OFFSET OF RECREBITS**—The amount of damages any person receives under paragraph (1), if any, shall be reduced by the amount, if any, that the claimant receives and retains as a recredit under section 7 or 8

(b) **COMPARATIVE NEGLIGENCE**—

(1) **IN GENERAL**—If a person incurs damages that resulted in whole or in part from the negligence or failure of that person to act in good faith, then the amount of any liability due to that person under subsection (a) shall be reduced in proportion to the amount of negligence or bad faith attributable to that person

(2) **RULE OF CONSTRUCTION**—Nothing in this subsection reduces the rights of a consumer or any other person under the Uniform Commercial Code or other applicable provision of Federal or State law

#### **SEC. 11. STATUTE OF LIMITATIONS AND NOTICE OF CLAIM.**

(a) **ACTIONS UNDER THIS ACT**—

(1) **IN GENERAL**—An action to enforce a claim under this Act may be brought in any United States district court, or in any other court of competent jurisdiction, before the end of the 1-year period beginning on the date the cause of action accrues

(2) **ACCRUAL**—A cause of action accrues as of the date the injured party first learns, or by which such person reasonably should have learned, of the facts and circumstances giving rise to the cause of action

(b) **DISCHARGE OF CLAIMS**—Except as provided in subsection (c), unless a person gives notice of a claim to the indemnifying or warranting bank within 30 days after the person has reason to know of the claim and the identity of the indemnifying or warranting bank, the indemnifying or warranting bank is discharged from liability in an action to enforce a claim under this Act to the extent of any loss caused by the delay in giving notice of the claim.

(c) **NOTICE OF CLAIM BY CONSUMER**—A timely claim by a consumer under section 7 for expedited recredit constitutes timely notice of a claim by the consumer for purposes of subsection (b)

#### **SEC. 12. CONSUMER AWARENESS.**

(a) **IN GENERAL**—Each bank shall provide, in accordance with subsection (b), a brief notice about substitute checks that describes—

(1) how a substitute check is the legal equivalent of an original check for all purposes, including any provision of any Federal or State law, and for all persons, if the substitute check—

(A) accurately represents all of the information on the front and back of the original check as of the time at which the original check was truncated; and

(B) bears the legend "This is a legal copy of your check. You can use it in the same way you would use the original check.", and

(2) the consumer recredit rights established under section 7 when a consumer believes in good faith that a substitute check was not properly charged to the account of the consumer

**(b) DISTRIBUTION —**

**(1) EXISTING CUSTOMERS —**With respect to consumers who are customers of a bank on the effective date of this Act and who receive original checks or substitute checks, a bank shall provide the notice described in subsection (a) to each such consumer no later than the first regularly scheduled communication with the consumer after the effective date of this Act

**(2) NEW ACCOUNT HOLDERS —**A bank shall provide the notice described in subsection (a) to each consumer who will receive original checks or substitute checks, other than existing customers referred to in paragraph (1), at the time at which the customer relationship is initiated

**(3) MODE OF DELIVERY.—**A bank may send the notices required by this subsection by United States mail or by any other means through which the consumer has agreed to receive account information

**(4) CONSUMERS WHO REQUEST COPIES OF CHECKS —**Notice shall be provided to each consumer of the bank that requests a copy of a check and receives a substitute check, at the time of the request.

**(c) MODEL LANGUAGE —**

**(1) IN GENERAL —**Before the end of the 9-month period beginning on the date of the enactment of this Act, the Board shall publish model forms and clauses that a bank may use to describe each of the elements required by subsection (a)

**(2) SAFE HARBOR.—**

**(A) IN GENERAL.—**A bank shall be treated as being in compliance with the requirements of subsection (a) if the bank's substitute check notice uses a model form or clause published by the Board and such model form or clause accurately describes the bank's policies and practices.

**(B) DELETION OR REARRANGEMENT.—**A bank may delete any information in the model form or clause that is not required by this Act or rearrange the format

**(3) USE OF MODEL LANGUAGE NOT REQUIRED.—**This section shall not be construed as requiring any bank to use a model form or clause that the Board prepares under this subsection

**SEC. 13. EFFECT ON OTHER LAW.**

This Act shall supersede any provision of Federal or State law, including the Uniform Commercial Code, that is inconsistent with this Act, but only to the extent of the inconsistency

**SEC. 14. VARIATION BY AGREEMENT.**

**(a) SECTION 8 —**Any provision of section 8 may be varied by agreement of the banks involved

**(b) NO OTHER PROVISIONS MAY BE VARIED —**Except as provided in subsection (a), no provision of this Act may be varied by agreement of any person or persons

**SEC. 15. REGULATIONS.**

The Board may prescribe such regulations as the Board determines to be necessary to implement, prevent circumvention or evasion of, or facilitate compliance with the provisions of this Act.

**SEC. 16. STUDY AND REPORT ON FUNDS AVAILABILITY.**

(a) **STUDY.**—In order to evaluate the implementation and the impact of this Act, the Board shall conduct a study of—

(1) the percentage of total checks cleared in which the paper check is not returned to the paying bank,

(2) the extent to which banks make funds available to consumers for local and nonlocal checks prior to the expiration of maximum hold periods;

(3) the length of time within which depository banks learn of the nonpayment of local and nonlocal checks;

(4) the increase or decrease in check-related losses over the study period, and

(5) the appropriateness of the time periods and amount limits applicable under sections 603 and 604 of the Expedited Funds Availability Act, as in effect on the date of enactment of this Act

(b) **REPORT TO CONGRESS**—Before the end of the 30-month period beginning on the effective date of this Act, the Board shall submit a report to the Congress containing the results of the study conducted under this section, together with recommendations for legislative action

**SEC. 17. STATISTICAL REPORTING OF COSTS AND REVENUES FOR TRANSPORTING CHECKS BETWEEN RESERVE BANKS.**

In the annual report prepared by the Board for the first full calendar year after the date of enactment of this Act and in each of the 9 subsequent annual reports by the Board, the Board shall include the amount of operating costs attributable to, and an estimate of the Federal Reserve banks' imputed revenues derived from, the transportation of commercial checks between Federal Reserve bank check processing centers

**SEC. 18. EVALUATION AND REPORT BY THE COMPTROLLER GENERAL.**

(a) **STUDY.**—During the 5-year period beginning on the date of the enactment of this Act, the Comptroller General of the United States shall evaluate the implementation and administration of this Act, including—

(1) an estimate of the gains in economic efficiency made possible from check truncation,

(2) an evaluation of the benefits accruing to consumers and financial institutions from reduced transportation costs, longer hours for accepting deposits for credit within 1 business day, the impact of fraud losses, and an estimate of consumers' share of the total benefits derived from this Act, and

(3) an assessment of consumer acceptance of the check truncation process resulting from this Act, as well as any new costs incurred by consumers who had their original checks returned with their regular monthly statements prior to the date of enactment of this Act

(b) **REPORT TO CONGRESS**—Before the end of the 5-year period referred to in subsection (a), the Comptroller General shall submit a report to the Congress containing the findings and conclusions of the Comptroller General in connection with the evaluation conducted pursuant to subsection (a), together with such recommendations for legislative and administrative action as the Comptroller General may determine to be appropriate.

**SEC. 19. DEPOSITARY SERVICES EFFICIENCY AND COST REDUCTION.**

(a) **FINDINGS**—*The Congress finds as follows:*

(1) The Secretary of the Treasury has long compensated financial institutions for various critical depositary and financial agency services provided for or on behalf of the United States by—

(A) placing large balances, commonly referred to as “compensating balances”, on deposit at such institutions, and

(B) using imputed interest on such funds to offset charges for the various depositary and financial agency services provided to or on behalf of the Government

(2) As a result of sharp declines in interest rates over the last few years to record low levels, or the public debt outstanding reaching the statutory debt limit, the Department of the Treasury often has had to dramatically increase or decrease the size of the compensating balances on deposit at these financial institutions

(3) The fluctuation of the compensating balances, and the necessary pledging of collateral by financial institutions to secure the value of compensating balances placed with those institutions, have created unintended financial uncertainty for the Secretary of the Treasury and for the management by financial institutions of their cash and securities.

(4) It is imperative that the process for providing financial services to the Government be transparent, and provide the information necessary for the Congress to effectively exercise its appropriation and oversight responsibilities.

(5) The use of direct payment for services rendered would strengthen cash and debt management responsibilities of the Secretary of the Treasury because the Secretary would no longer need to dramatically increase or decrease the level of such balances when interest rates fluctuate sharply or when the public debt outstanding reaches the statutory debt limit

(6) An alternative to the use of compensating balances, such as direct payments to financial institutions, would ensure that payments to financial institutions for the services they provide would be made in a more predictable manner and could result in cost savings

(7) Limiting the use of compensating balances could result in a more direct and cost-efficient method of obtaining those services currently provided under compensating balance arrangements

(8) A transition from the use of compensating balances to another compensation method must be carefully managed to prevent higher-than-necessary transitional costs and enable participating financial institutions to modify their planned investment of cash and securities

(b) **AUTHORIZATION OF APPROPRIATIONS FOR SERVICES RENDERED BY DEPOSITARIES AND FINANCIAL AGENCIES OF THE UNITED STATES.**—There are authorized to be appropriated for fiscal years beginning after fiscal year 2003 to the Secretary of the Treasury such sums as may be necessary for reimbursing financial institutions in their capacity as depositaries and financial agents of the United States for all services required or directed by the Secretary

of the Treasury, or a designee of the Secretary, to be performed by such financial institutions on behalf of the Secretary of the Treasury or another Federal agency, including services rendered before fiscal year 2004

(c) ORDERLY TRANSITION.—

(1) IN GENERAL.—As appropriations authorized in subsection (b) become available, the Secretary of the Treasury shall promptly begin the process of phasing in the use of the appropriations to pay financial institutions serving as depositaries and financial agents of the United States, and transitioning from the use of compensating balances to fund these services

(2) POST-TRANSITION USE LIMITED TO EXTRAORDINARY CIRCUMSTANCES.—

(A) IN GENERAL.—Following the transition to the use of the appropriations authorized in subsection (b), the Secretary of the Treasury may use the compensating balances to pay financial institutions serving as depositaries and financial agents of the United States only in extraordinary situations where the Secretary determines that they are needed to ensure the fiscal operations of the Government continue to function in an efficient and effective manner

(B) REPORT.—Any use of compensating balances pursuant to subparagraph (A) shall promptly be reported by the Secretary of the Treasury to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate

(3) REQUIREMENTS FOR ORDERLY TRANSITION.—In transitioning to the use of the appropriations authorized in subsection (b), the Secretary of the Treasury shall take such steps as may be appropriate to—

(A) prevent abrupt financial disruption to the functions of the Department of the Treasury or to the participating financial institutions; and

(B) maintain adequate accounting and management controls to ensure that payments to financial institutions for their banking services provided to the Government as depositaries and financial agents are accurate and that the arrangements last no longer than is necessary.

(4) REPORTS REQUIRED.—

(A) ANNUAL REPORT.—

(i) IN GENERAL.—For each fiscal year, the Secretary of the Treasury shall submit a report to the Congress on the use of compensating balances and on the use of appropriations authorized in subsection (b) during that fiscal year

(ii) INCLUSION IN BUDGET.—The report required under clause (i) may be submitted as part of the budget submitted by the President under section 1105 of the title 31, United States Code, for the following fiscal year and if so, the report shall be submitted concurrently to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate

(B) FINAL REPORT FOLLOWING TRANSITION.—

(i) *IN GENERAL.*—Following completion of the transition from the use of compensating balances to the use of the appropriations authorized in subsection (b) to pay financial institutions for their services as depositaries and financial agents of the United States, the Secretary of the Treasury shall submit a report on the transition to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate.

(ii) *CONTENTS OF REPORT.*—The report submitted under clause (i) shall include a detailed analysis of—

(I) the cost of transition,

(II) the direct costs of the services being paid from the appropriations authorized in subsection (b), and

(III) the benefits realized from the use of direct payment for such services, rather than the use of compensating balance arrangements

(d) *TECHNICAL AMENDMENT.*—The 2d undesignated paragraph of section 16 of the Federal Reserve Act (12 U S C 412) is amended—

(1) in the 3d sentence, by inserting "or any other asset of a Federal reserve bank" before the period at the end, and

(2) in the last sentence, by inserting "; or are otherwise held by or on behalf of," after "in the vaults of".

(e) *EFFECTIVE DATE.*—Notwithstanding section 20, this section shall take effect on the date of the enactment of this Act

**SEC. 20. EFFECTIVE DATE.**

*This Act shall take effect at the end of the 12-month period beginning on the date of the enactment of this Act, except as otherwise specifically provided in this Act.*

And the Senate agree to the same

For consideration of the House bill and the Senate amendment, and modifications committed to conference

MICHAEL G. OXLEY,  
SPENCER BACHUS,  
STEVEN C. LATOURETTE,  
MELISSA A. HART,  
PATRICK J. TIBERI,  
BARNEY FRANK,  
HAROLD E. FORD, Jr.,

*Managers on the Part of the House.*

RICHARD C. SHELBY,  
ROBERT F. BENNETT,  
WAYNE ALLARD,  
PAUL S. SARBANES,  
TIM JOHNSON,

*Managers on the Part of the Senate*

**UPDATE FROM THE CHICAGO REGIONAL  
OFFICE OF THE FDIC**

*Timothy E. Divis  
Regional Counsel  
Federal Deposit Insurance Corporation  
Chicago, Illinois*

Copyright 2004. All Rights Reserved.

**SECTION G**

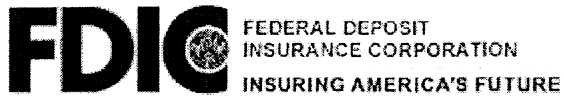




**UPDATE FROM THE CHICAGO REGIONAL  
OFFICE OF THE FDIC**

- I. 2000 - FDIC RULES AND REGULATIONS**  
**Part 359 - Golden Parachute and Indemnification Payments ..... G-1**
  
- II. FINANCIAL INSTITUTION LETTERS**  
**Unfair or Deceptive Acts or Practices by State-Chartered Banks ..... G-9**
  
- III. FINANCIAL INSTITUTION LETTERS**  
**12 CFR Parts 303 and 324**  
**Filing Procedures; Transactions With Affiliates ..... G-17**
  
- IV. RULES AND REGULATIONS**  
**12 CFR Part 330**  
**Deposit Insurance Regulations; Living Trust Accounts ..... G-37**





## FDIC Law, Regulations, Related Acts

### 2000 - FDIC RULES AND REGULATIONS

[\[Main Tabs\]](#) [\[Table of Contents - 2000\]](#) [\[Index\]](#) [\[Previous Page\]](#) [\[Next Page\]](#) [\[Search\]](#)

{{8-31-98 p.3079}}

#### PART 359—GOLDEN PARACHUTE AND INDEMNIFICATION PAYMENTS

Sec.

[359.0 Scope.](#)

[359.1 Definitions.](#)

[359.2 Golden parachute payments prohibited.](#)

[359.3 Prohibited indemnification payments.](#)

[359.4 Permissible golden parachute payments.](#)

[359.5 Permissible indemnification payments.](#)

[359.6 Filing instructions.](#)

[359.7 Applicability in the event of receivership.](#)

**Authority:** 12 U.S.C. 1828(k).

**SOURCE:** The provisions of this part 359 appear at 61 Fed. Reg. 5930, February 5, 1996, except as otherwise noted.

#### § 359.0 Scope.

(a) This part limits and/or prohibits, in certain circumstances, the ability of insured depository institutions, their subsidiaries and affiliated depository institution holding companies to enter into contracts to pay and to make golden parachute and indemnification payments to institution-affiliated parties (IAPs).

(b) The limitations on golden parachute payments apply to troubled insured depository institutions which seek to enter into contracts to pay or to make golden parachute payments to their IAPs. The limitations also apply to depository institution holding companies which are troubled and seek to enter into contracts to pay or to make golden parachute payments to their IAPs as well as healthy holding companies which seek to enter into contracts to pay or to make golden parachute payments to IAPs of a troubled insured depository institution subsidiary. A "golden parachute payment" is generally considered to be any payment to an IAP which is contingent on the termination of that person's employment and is received when the insured depository institution making the payment is troubled or, if the payment is being made by an affiliated holding company, either the holding company itself or the insured depository institution employing the IAP, is troubled. The definition of golden parachute payment does not include payments pursuant to qualified retirement plans, nonqualified bona fide deferred compensation plans, nondiscriminatory severance pay plans, other types of common benefits plans, state statutes and death benefits. Certain limited exceptions to the golden parachute payment prohibition are provided for in cases involving the hiring of a white knight and unassisted changes in control. A procedure is also set forth whereby an institution or IAP can request permission to make what would otherwise be a prohibited golden parachute payment.

(c) The limitations on indemnification payments apply to all insured depository institutions, their subsidiaries and affiliated depository institution holding companies regardless of their financial health. Generally, this part prohibits insured depository institutions, their subsidiaries and affiliated holding

companies from indemnifying an IAP for that portion of the costs sustained with regard to an administrative or civil enforcement action commenced by any federal banking agency which results in a final order or settlement pursuant to which the IAP is assessed a civil money penalty, removed from office, prohibited from participating in the affairs of an insured depository institution or required to cease and desist from or take an affirmative action described in section 8(b) (12 U.S.C. 1818(b)) of the Federal Deposit Insurance Act (FDI Act). However, there are exceptions to this general prohibition. First, an institution or holding company may purchase commercial insurance to cover such expenses, except judgments and penalties. Second, the institution or holding company may advance legal and other professional expenses to an IAP directly (except for judgments and penalties) if its board of directors makes certain specific findings and the IAP agrees in writing to reimburse the institution if it is ultimately determined that the IAP violated a law, regulation or other fiduciary duty. {{8-31-98 p.3080}}

[Codified to 12 C.F.R. § 359.0]

### § 359.1 Definitions.

- (a) *Act* means the Federal Deposit Insurance Act, as amended (12 U.S.C. 1811, *et seq.*).
- (b) *Appropriate federal banking agency, bank holding company, depository institution holding company and savings and loan holding company* have the meanings given to such terms in section 3 of the Act.
- (c) *Benefit plan* means any plan, contract, agreement or other arrangement which is an "employee welfare benefit plan" as that term is defined in section 3(1) of the Employee Retirement Income Security Act of 1974, as amended (29 U.S.C. 1002(1)), or other usual and customary plans such as dependent care, tuition reimbursement, group legal services or cafeteria plans; provided however, that such term shall not include any plan intended to be subject to paragraphs (f)(2) (iii) and (v) of this section.
- (d) *Bona fide deferred compensation plan or arrangement* means any plan, contract, agreement or other arrangement whereby:
  - (1) An IAP voluntarily elects to defer all or a portion of the reasonable compensation, wages or fees paid for services rendered which otherwise would have been paid to such party at the time the services were rendered (including a plan that provides for the crediting of a reasonable investment return on such elective deferrals) and the insured depository institution or depository institution holding company either:
    - (i) Recognizes compensation expense and accrues a liability for the benefit payments according to generally accepted accounting principles (GAAP); or
    - (ii) Segregates or otherwise sets aside assets in a trust which may only be used to pay plan and other benefits, except that the assets of such trust may be available to satisfy claims of the institution's or holding company's creditors in the case of insolvency; or
  - (2) An insured depository institution or depository institution holding company establishes a nonqualified deferred compensation or supplemental retirement plan, other than an elective deferral plan described in paragraph (e)(1) of this section:
    - (i) Primarily for the purpose of providing benefits for certain IAPS in excess of the limitations on contributions and benefits imposed by sections 415, 401(a)(17), 402(g) or any other applicable provision of the Internal Revenue Code of 1986 (26 U.S.C. 415, 401(a)(17), 402(g)); or
    - (ii) Primarily for the purpose of providing supplemental retirement benefits or other deferred compensation for a select group of directors, management or highly compensated employees (excluding severance payments described in paragraph (f)(2)(v) of this section and permissible golden parachute payments described in § 359.4); and
  - (3) In the case of any nonqualified deferred compensation or supplemental retirement plans as described in paragraphs (d) (1) and (2) of this section, the following requirements shall apply:
    - (i) The plan was in effect at least one year prior to any of the events described in paragraph (f)(1) (ii) of this section;
    - (ii) Any payment made pursuant to such plan is made in accordance with the terms of the plan as in effect no later than one year prior to any of the events described in paragraph (f)(1)(ii) of this section and in accordance with any amendments to such plan during such one year period that do not increase the benefits payable thereunder;
    - (iii) The IAP has a vested right, as defined under the applicable plan document, at the time of termination of employment to payments under such plan;

- (iv) Benefits under such plan are accrued each period only for current or prior service rendered to the employer (except that an allowance may be made for service with a predecessor employer);
- (v) Any payment made pursuant to such plan is not based on any discretionary acceleration of vesting or accrual of benefits which occurs at any time later than one year prior to any of the events described in paragraph (f)(i)(ii) of this section;  
{{8-29-03 p.3081}}
- (vi) The insured depository institution or depository institution holding company has previously recognized compensation expense and accrued a liability for the benefit payments according to GAAP or segregated or otherwise set aside assets in a trust which may only be used to pay plan benefits, except that the assets of such trust may be available to satisfy claims of the institution's or holding company's creditors in the case of insolvency; and
- (vii) Payments pursuant to such plans shall not be in excess of the accrued liability computed in accordance with GAAP.
- (e) *Corporation* means the Federal Deposit Insurance Corporation, in its corporate capacity.
- (f) *Golden parachute payment.* (1) The term *golden parachute payment* means any payment (or any agreement to make any payment) in the nature of compensation by any insured depository institution or an affiliated depository institution holding company for the benefit of any current or former IAP pursuant to an obligation of such institution or holding company that:
  - (i) Is contingent on, or by its terms is payable on or after, the termination of such party's primary employment or affiliation with the institution or holding company; and
  - (ii) Is received on or after, or is made in contemplation of, any of the following events:
    - (A) The insolvency (or similar event) of the insured depository institution which is making the payment or bankruptcy or insolvency (or similar event) of the depository institution holding company which is making the payment; or
    - (B) The appointment of any conservator or receiver for such insured depository institution; or
    - (C) A determination by the insured depository institution's or depository institution holding company's appropriate federal banking agency, respectively, that the insured depository institution or depository institution holding company is in a troubled condition, as defined in the applicable regulations of the appropriate federal banking agency (§ 303.101(c) of this chapter); or
    - (D) The insured depository institution is assigned a composite rating of 4 or 5 by the appropriate federal banking agency or informed in writing by the Corporation that it is rated a 4 or 5 under the Uniform Financial Institutions Rating System of the Federal Financial Institutions Examination Council, or the depository institution holding company is assigned a composite rating of 4 or 5 or unsatisfactory by its appropriate federal banking agency; or
    - (E) The insured depository institution is subject to a proceeding to terminate or suspend deposit insurance for such institution; and
  - (iii)(A) Is payable to an IAP whose employment by or affiliation with an insured depository institution is terminated at a time when the insured depository institution by which the IAP is employed or with which the IAP is affiliated satisfies any of the conditions enumerated in paragraphs (f)(i)(ii) (A) through (E) of this section, or in contemplation of any of these conditions; or
  - (B) Is payable to an IAP whose employment by or affiliation with an insured depository institution holding company is terminated at a time when the insured depository institution holding company by which the IAP is affiliated satisfies any of the conditions enumerated in paragraphs (f)(1)(ii)(A),(C) or (D) of this section, or in contemplation of any of these conditions.
- (2) *Exceptions.* The term *golden parachute payment* shall not include:
  - (i) Any payment made pursuant to a pension or retirement plan which is qualified (or is intended within a reasonable period of time to be qualified) under section 401 of the Internal Revenue Code of 1986 (26 U.S.C. 401) or pursuant to a pension or other retirement plan which is governed by the laws of any foreign country; or
  - (ii) Any payment made pursuant to a benefit plan as that term is defined in paragraph (c) of this section; or  
{{8-29-03 p.3082}}
  - (iii) Any payment made pursuant to a *bona fide* deferred compensation plan or arrangement as defined in paragraph (d) of this section; or
  - (iv) Any payment made by reason of death or by reason of termination caused by the disability of an institution-affiliated party; or
  - (v) Any payment made pursuant to a nondiscriminatory severance pay plan or arrangement which provides for payment of severance benefits to all eligible employees upon involuntary termination other than for cause, voluntary resignation, or early retirement; *provided, however*, that no employee shall receive any such payment which exceeds the base compensation paid to such employee during the

twelve months (or such longer period or greater benefit as the Corporation shall consent to) immediately preceding termination of employment, resignation or early retirement, and such severance pay plan or arrangement shall not have been adopted or modified to increase the amount or scope of severance benefits at a time when the insured depository institution or depository institution holding company was in a condition specified in paragraph (f)(1)(ii) of this section or in contemplation of such a condition without the prior written consent of the appropriate federal banking agency; or

(vi) Any severance or similar payment which is required to be made pursuant to a state statute or foreign law which is applicable to all employers within the appropriate jurisdiction (with the exception of employers that may be exempt due to their small number of employees or other similar criteria); or

(vii) Any other payment which the Corporation determines to be permissible in accordance with § 359.4.

(g) *Insured depository institution* means any bank or savings association the deposits of which are insured by the Corporation pursuant to the Act, or any subsidiary thereof.

(h) *Institution-affiliated party (IAP)* means:

(1) Any director, officer, employee, or controlling stockholder (other than a depository institution holding company) of, or agent for, an insured depository institution or depository institution holding company;

(2) Any other person who has filed or is required to file a change-in- control notice with the appropriate federal banking agency under section 7(j) of the Act (12 U.S.C. 1817(j));

(3) Any shareholder (other than a depository institution holding company), consultant, joint venture partner, and any other person as determined by the appropriate federal banking agency (by regulation or case-by-case) who participates in the conduct of the affairs of an insured depository institution or depository institution holding company; and

(4) Any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in: Any violation of any law or regulation, any breach of fiduciary duty, or any unsafe or unsound practice, which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution or depository institution holding company.

(i) *Liability or legal expense* means:

(1) Any legal or other professional fees and expenses incurred in connection with any claim, proceeding, or action;

(2) The amount of, and any cost incurred in connection with, any settlement of any claim, proceeding, or action; and

(3) The amount of, and any cost incurred in connection with, any judgment or penalty imposed with respect to any claim, proceeding, or action.

(j) *Nondiscriminatory* means that the plan, contract or arrangement in question applies to all employees of an insured depository institution or depository institution holding company who meet reasonable and customary eligibility requirements applicable to all employees, such as minimum length of service requirements. A nondiscriminatory plan, contract or arrangement may provide different benefits based only on objective criteria such as salary, total compensation, length of service, job grade or classification, which are applied on a proportionate basis (with a variance in severance benefits relating to any

{{8-29-03 p.3082.01}}criterion of plus or minus ten percent) to groups of employees consisting of not less than the lesser of 33 percent of employees or 1,000 employees.

(k) *Payment* means:

(1) Any direct or indirect transfer of any funds or any asset;

(2) Any forgiveness of any debt or other obligation;

(3) The conferring of any benefit, including but not limited to stock options and stock appreciation rights; and

(4) Any segregation of any funds or assets, the establishment or funding of any trust or the purchase of or arrangement for any letter of credit or other instrument, for the purpose of making, or pursuant to any agreement to make, any payment on or after the date on which such funds or assets are segregated, or at the time of or after such trust is established or letter of credit or other instrument is made available, without regard to whether the obligation to make such payment is contingent on:

(i) The determination, after such date, of the liability for the payment of such amount; or

(ii) The liquidation, after such date, of the amount of such payment.

(1) *Prohibited indemnification payment.* (1) The term *prohibited indemnification payment* means any payment (or any agreement or arrangement to make any payment) by any insured depository institution or an affiliated depository institution holding company for the benefit of any person who is or was an IAP of such insured depository institution or holding company, to pay or reimburse such person

for any civil money penalty or judgment resulting from any administrative or civil action instituted by any federal banking agency, or any other liability or legal expense with regard to any administrative proceeding or civil action instituted by any federal banking agency which results in a final order or settlement pursuant to which such person:

- (i) Is assessed a civil money penalty;
- (ii) Is removed from office or prohibited from participating in the conduct of the affairs of the insured depository institution; or
- (iii) Is required to cease and desist from or take any affirmative action described in section 8(b) of the Act with respect to such institution.

(2) *Exceptions.* (i) The term *prohibited indemnification payment* shall not include any reasonable payment by an insured depository institution or depository institution holding company which is used to purchase any commercial insurance policy of fidelity bond, provided that such insurance policy or bond shall not be used to pay or reimburse an IAP for the cost of any judgment or civil money penalty assessed against such person in an administrative proceeding or civil action commenced by any federal banking agency, but may pay any legal or professional expenses incurred in connection with such proceeding or action or the amount of any restitution, to the insured depository institution, depository institution holding company or receiver.

(ii) The term *prohibited indemnification payment* shall not include any reasonable payment by an insured depository institution or depository institution holding company that represents partial indemnification for legal or professional expenses specifically attributable to particular charges for which there has been a formal and final adjudication or finding in connection with a settlement that the IAP has not violated certain banking laws or regulations or has not engaged in certain unsafe or unsound banking practices or breaches of fiduciary duty, unless the administrative action or civil proceeding has resulted in a final prohibition order against the IAP.

[Codified to 12 C.F.R. § 359.1]

[Section 359.1 amended at 68 Fed. Reg. 50461, August 21, 2003, effective September 22, 2003]

#### **§ 359.2 Golden parachute payments prohibited.**

No insured depository institution or depository institution holding company shall make or agree to make any golden parachute payment, except as provided in this part.

[Codified to 12 C.F.R. § 359.2]

{{8-29-03 p.3082.02}}

#### **§ 359.3 Prohibited indemnification payments.**

No insured depository institution or depository institution holding company shall make or agree to make any prohibited indemnification payment, except as provided in this part.

[Codified to 12 C.F.R. § 359.3]

#### **§ 359.4 Permissible golden parachute payments.**

(a) An insured depository institution or depository institution holding company may agree to make or may make a golden parachute payment if and to the extent that:

- (1) The appropriate federal banking agency, with the written concurrence of the Corporation, determines that such a payment or agreement is permissible; or
- (2) Such an agreement is made in order to hire a person to become an IAP either at a time when the insured depository institution or depository institution holding company satisfies or in an effort to prevent it from imminently satisfying any of the criteria set forth in § 359.1(f)(1) (ii), and the institution's appropriate federal banking agency and the Corporation consent in writing to the amount and terms of the golden parachute payment. Such consent by the FDIC and the institution's appropriate federal banking agency shall not improve the IAP's position in the event of the insolvency of the institution since such consent can neither bind a receiver nor affect the provability of receivership claims. In the

event that the institution is placed into receivership or conservatorship, the FDIC and/or the institution's appropriate federal banking agency shall not be obligated to pay the promised golden parachute and the IAP shall not be accorded preferential treatment on the basis of such prior approval; or

(3) Such a payment is made pursuant to an agreement which provides for a reasonable severance payment, not to exceed twelve months salary, to an IAP in the event of a change in control of the insured depository institution; *provided, however*, that an insured depository institution or depository institution holding company shall obtain the consent of the appropriate federal banking agency prior to making such a payment and this paragraph (a)(3) shall not apply to any change in control of an insured depository institution which results from an assisted transaction as described in section 13 of the Act (12 U.S.C. 1823) or the insured depository institution being placed into conservatorship or receivership; and

(4) An insured depository institution, depository institution holding company or IAP making a request pursuant to paragraphs (a)(1) through (3) of this section shall demonstrate that it does not possess and is not aware of any information, evidence, documents or other materials which would indicate that there is a reasonable basis to believe, at the time such payment is proposed to be made, that:

(i) The IAP has committed any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the depository institution or depository institution holding company that has had or is likely to have a material adverse effect on the institution or holding company;

(ii) The IAP is substantially responsible for the insolvency of, the appointment of a conservator or receiver for, or the troubled condition, as defined by applicable regulations of the appropriate federal banking agency, of the insured depository institution, depository institution holding company or any insured depository institution subsidiary of such holding company;

(iii) The IAP has materially violated any applicable federal or state banking law or regulation that has had or is likely to have a material effect on the insured depository institution or depository institution holding company; and

(iv) The IAP has violated or conspired to violate section 215, 656, 657, 1005, 1006, 1007, 1014, 1032, or 1344 of title 18 of the United States Code, or section 1341 or 1343 of such title affecting a federally insured financial institution as defined in title 18 of the United States Code.  
{{8-31-98 p.3082.03}}

(b) In making a determination under paragraphs (a) (1) through (3) of this section, the appropriate federal banking agency and the Corporation may consider:

(1) Whether, and to what degree, the IAP was in a position of managerial or fiduciary responsibility;

(2) The length of time the IAP was affiliated with the insured depository institution or depository institution holding company, and the degree to which the proposed payment represents a reasonable payment for services rendered over the period of employment; and

(3) Any other factors or circumstances which would indicate that the proposed payment would be contrary to the intent of section 18(k) of the Act or this part.

[Codified to 12 C.F.R. § 359.4]

#### **§ 359.5 Permissible indemnification payments.**

(a) An insured depository institution or depository institution holding company may make or agree to make reasonable indemnification payments to an IAP with respect to an administrative proceeding or civil action initiated by any federal banking agency if:

(1) The insured depository institution's or depository institution holding company's board of directors, in good faith, determines in writing after due investigation and consideration that the institution-affiliated party acted in good faith and in a manner he/she believed to be in the best interests of the institution;

(2) The insured depository institution's or depository institution holding company's board of directors, respectively, in good faith, determines in writing after due investigation and consideration that the payment of such expenses will not materially adversely affect the institution's or holding company's safety and soundness;

(3) The indemnification payments do not constitute prohibited indemnification payments as that term is defined in § 359.1(1); and

(4) The IAP agrees in writing to reimburse the insured depository institution or depository institution holding company, to the extent not covered by payments from insurance or bonds purchased pursuant to § 359.1(1)(2), for that portion of the advanced indemnification payments which subsequently



become prohibited indemnification payments, as defined in § 359.1(1).

(b) An IAP requesting indemnification payments shall not participate in any way in the board's discussion and approval of such payments; *provided, however*, that such IAP may present his/her request to the board and respond to any inquiries from the board concerning his/her involvement in the circumstances giving rise to the administrative proceeding or civil action.

(c) In the event that a majority of the members of the board of directors are named as respondents in an administrative proceeding or civil action and request indemnification, the remaining members of the board may authorize independent legal counsel to review the indemnification request and provide the remaining members of the board with a written opinion of counsel as to whether the conditions delineated in paragraph (a) of this section have been met. If independent legal counsel opines that said conditions have been met, the remaining members of the board of directors may rely on such opinion in authorizing the requested indemnification.

(d) In the event that all of the members of the board of directors are named as respondents in an administrative proceeding or civil action and request indemnification, the board shall authorize independent legal counsel to review the indemnification request and provide the board with a written opinion of counsel as to whether the conditions delineated in paragraph (a) of this section have been met. If independent legal counsel opines that said conditions have been met, the board of directors may rely on such opinion in authorizing the requested indemnification.

*[Codified to 12 C.F.R. § 359.5]*

{{8-31-98 p.3082.04}}

#### **§ 359.6 Filing instructions.**

Requests to make excess nondiscriminatory severance plan payments pursuant to § 359.1(f)(2)(v) and golden parachute payments permitted by § 359.4 shall be submitted in writing to the appropriate regional director (DOS). For filing requirements, consult 12 CFR 303.244. In the event that the consent of the institution's primary federal regulator is required in addition to that of the FDIC, the requesting party shall submit a copy of its letter to the FDIC to the institution's primary federal regulator. In the case of national banks, such written requests shall be submitted to the OCC. In the case of state member banks and bank holding companies, such written requests shall be submitted to the Federal Reserve district bank where the institution or holding company, respectively, is located. In the case of savings associations and savings association holding companies, such written requests shall be submitted to the OTS regional office where the institution or holding company, respectively, is located. In cases where only the prior consent of the institution's primary federal regulator is required and that agency is not the FDIC, a written request satisfying the requirements of this section shall be submitted to the primary federal regulator as described in this section.

*[Codified to 12 C.F.R. § 359.6]*

*[Section 359.6 amended at 63 Fed. Reg. 44751 August 20, 1998, effective October 1, 1998]*

#### **§ 359.7 Applicability in the event of receivership.**

The provisions of this part, or any consent or approval granted under the provisions of this part by the FDIC (in its corporate capacity), shall not in any way bind any receiver of a failed insured depository institution. Any consent or approval granted under the provisions of this part by the FDIC or any other federal banking agency shall not in any way obligate such agency or receiver to pay any claim or obligation pursuant to any golden parachute, severance indemnification or other agreement. Claims for employee welfare benefits or other benefits which are contingent, even if otherwise vested, when the FDIC is appointed as receiver for any depository institution, including any contingency for termination of employment, are not provable claims or actual, direct compensatory damage claims against such receiver. Nothing in this part may be construed to permit the payment of salary or any liability or legal expense of any IAP contrary to 12 U.S.C. 1828(k)(3).

*[Codified to 12 C.F.R. § 359.7]*



## Financial Institution Letters

---

### Unfair or Deceptive Acts or Practices by State-Chartered Banks

FIL-26-2004  
March 11, 2004

**TO:** CHIEF EXECUTIVE OFFICER (also of interest to Compliance Officer)  
**SUBJECT:** Unfair or Deceptive Acts or Practices Under Section 5 of the Federal Trade Commission Act  
**Summary:** *The FDIC and the Board of Governors of the Federal Reserve System are issuing guidance to state-chartered banks to outline the standards that the agencies will consider when applying the prohibitions against unfair or deceptive acts or practices found in section 5 of the Federal Trade Commission Act. The guidance also provides information about managing risks relating to unfair or deceptive acts or practices, including best practices.*

The Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve System are jointly issuing the attached guidance to state-chartered banks regarding unfair or deceptive acts or practices prohibited by section 5 of the Federal Trade Commission (FTC) Act.

In FIL-57-2002, issued May 30, 2002, the FDIC informed state nonmember banks that these prohibitions apply to their activities, and that the FDIC would issue guidance about how institutions could avoid engaging in practices that might be viewed as unfair or deceptive. In its corresponding release, the Federal Reserve Board indicated that it would work with the FDIC to prepare additional guidance for state member banks on this subject. The attached guidance fulfills these commitments.

Specifically, the guidance explains:

- the standards used to assess whether an act or practice is unfair or deceptive;
- the interplay between the FTC Act and other consumer protection statutes; and
- guidelines for managing risks related to unfair and deceptive practices.

Although most insured banks adhere to high levels of professional conduct, managers of all banks must remain vigilant against possible unfair or deceptive acts or practices to protect consumers and to minimize their own risk.

For more information about the guidance, please contact April P. Breslaw, Section Chief (202- 898-6609); Deirdre Foley, Senior Policy Analyst (202-898-6612); or Mira N. Marshall, Senior Policy Analyst (202-898-3912), in the Division of Supervision and Consumer Protection.

For your reference, FDIC Financial Institution Letters (FILs) may be accessed from the FDIC's Web site at [www.fdic.gov/news/news/financial/2004/index.html](http://www.fdic.gov/news/news/financial/2004/index.html).

Michael J. Zamorski  
Director  
Division of Supervision and Consumer Protection

## Financial Institution Letters

---

Board of Governors of the Federal Reserve System  
Federal Deposit Insurance Corporation

---

### Unfair or Deceptive Acts or Practices by State-Chartered Banks March 11, 2004

#### Purpose

The Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (the "Board" and the "FDIC," or collectively, the "Agencies") are issuing this statement to outline the standards that will be considered by the Agencies as they carry out their responsibility to enforce the prohibitions against unfair or deceptive trade practices found in section 5 of the Federal Trade Commission Act ("FTC Act") as they apply to acts and practices of state-chartered banks. The Agencies will apply these standards when weighing the need to take supervisory and enforcement actions and when seeking to ensure that unfair or deceptive practices do not recur.

This statement also contains a section on managing risks relating to unfair or deceptive acts or practices, which includes best practices as well as general guidance on measures that state-chartered banks can take to avoid engaging in such acts or practices.

Although the majority of insured banks adhere to a high level of professional conduct, banks must remain vigilant against possible unfair or deceptive acts or practices both to protect consumers and to minimize their own risks.

#### Coordination of Enforcement Efforts

Section 5(a) of the FTC Act prohibits "unfair or deceptive acts or practices in or affecting commerce," and applies to all persons engaged in commerce, including banks. The Agencies each have affirmed their authority under section 8 of the Federal Deposit Insurance Act to take appropriate action when unfair or deceptive acts or practices are discovered.

A number of agencies have authority to combat unfair or deceptive acts or practices. For example, the FTC has broad authority to enforce the requirements of section 5 of the FTC Act against many non-bank entities. In addition, state authorities have primary responsibility for enforcing state statutes against unfair or deceptive acts or practices. The Agencies intend to work with these other regulators as appropriate in investigating and responding to allegations of unfair or deceptive acts or practices that involve state banks and other entities supervised by the Agencies.

#### Standards for Determining What is Unfair or Deceptive

The FTC Act prohibits unfair or deceptive acts or practices. Congress drafted this provision broadly in order to provide sufficient flexibility in the law to address changes in the market and unfair or deceptive practices that may emerge.

An act or practice may be found to be unfair where it “causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition.” A representation, omission, or practice is deceptive if it is likely to mislead a consumer acting reasonably under the circumstances and is likely to affect a consumer’s conduct or decision regarding a product or service.

The standards for unfairness and deception are independent of each other. While a specific act or practice may be both unfair and deceptive, an act or practice is prohibited by the FTC Act if it is either unfair or deceptive. Whether an act or practice is unfair or deceptive will in each instance depend upon a careful analysis of the facts and circumstances. In analyzing a particular act or practice, the Agencies will be guided by the body of law and official interpretations for defining unfair or deceptive acts or practices developed by the courts and the FTC. The Agencies will also consider factually similar cases brought by the FTC and other agencies to ensure that these standards are applied consistently.

## **Unfair Acts or Practices**

### ***Assessing whether an act or practice is unfair***

An act or practice is unfair where it (1) causes or is likely to cause substantial injury to consumers, (2) cannot be reasonably avoided by consumers, and (3) is not outweighed by countervailing benefits to consumers or to competition. Public policy may also be considered in the analysis of whether a particular act or practice is unfair. Each of these elements is discussed further below.

- The act or practice must cause or be likely to cause substantial injury to consumers.

To be unfair, an act or practice must cause or be likely to cause substantial injury to consumers. Substantial injury usually involves monetary harm. An act or practice that causes a small amount of harm to a large number of people may be deemed to cause substantial injury. An injury may be substantial if it raises a significant risk of concrete harm. Trivial or merely speculative harms are typically insufficient for a finding of substantial injury. Emotional impact and other more subjective types of harm will not ordinarily make a practice unfair.

- Consumers must not reasonably be able to avoid the injury.

A practice is not considered unfair if consumers may reasonably avoid injury. Consumers cannot reasonably avoid injury from an act or practice if it interferes with their ability to effectively make decisions. Withholding material price information until after the consumer has committed to purchase the product or service would be an example of preventing a consumer from making an informed decision. A practice may also be unfair where consumers are subject to undue influence or are coerced into purchasing unwanted products or services.

The Agencies will not second-guess the wisdom of particular consumer decisions. Instead, the Agencies will consider whether a bank’s behavior unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decision-making.

- The injury must not be outweighed by countervailing benefits to consumers or to competition.

To be unfair, the act or practice must be injurious in its net effects —that is, the injury must not be outweighed by any offsetting consumer or competitive benefits that are also produced by the act or practice. Offsetting benefits may include lower prices or a wider availability of products and services.

Costs that would be incurred for remedies or measures to prevent the injury are also taken into account in determining whether an act or practice is unfair. These costs may include the costs to the bank in taking preventive measures and the costs to society as a whole of any increased burden and similar matters.

- Public policy may be considered.

Public policy, as established by statute, regulation, or judicial decisions may be considered with all other evidence in determining whether an act or practice is unfair. For example, the fact that a particular lending practice violates a state law or a banking regulation may be considered as evidence in determining whether the act or practice is unfair. Conversely, the fact that a particular practice is affirmatively allowed by statute may be considered as evidence that the practice is not unfair. Public policy considerations by themselves, however, will not serve as the primary basis for determining that an act or practice is unfair.

## **Deceptive Acts and Practices**

### ***Assessing whether an act or practice is deceptive***

A three-part test is used to determine whether a representation, omission, or practice is "deceptive." First, the representation, omission, or practice must mislead or be likely to mislead the consumer. Second, the consumer's interpretation of the representation, omission, or practice must be reasonable under the circumstances. Lastly, the misleading representation, omission, or practice must be material. Each of these elements is discussed below in greater detail.

- There must be a representation, omission, or practice that misleads or is likely to mislead the consumer.

An act or practice may be found to be deceptive if there is a representation, omission, or practice that misleads or is likely to mislead the consumer. Deception is not limited to situations in which a consumer has already been misled. Instead, an act or practice may be found to be deceptive if it is likely to mislead consumers. A representation may be in the form of express or implied claims or promises and may be written or oral. Omission of information may be deceptive if disclosure of the omitted information is necessary to prevent a consumer from being misled.

In determining whether an individual statement, representation, or omission is misleading, the statement, representation, or omission will not be evaluated in isolation. The Agencies will evaluate it in the context of the entire advertisement, transaction, or course of dealing to determine whether it constitutes deception. Acts or practices that have the potential to be deceptive include: making misleading cost or price claims; using bait-and-switch techniques; offering to provide a product or service that is not in fact available; omitting material limitations or conditions from an offer; selling a product unfit for the purposes for which it is sold; and failing to provide promised services.

- The act or practice must be considered from the perspective of the reasonable consumer.

In determining whether an act or practice is misleading, the consumer's interpretation of or reaction to the representation, omission, or practice must be reasonable under the circumstances. The test is whether the consumer's expectations or interpretation are reasonable in light of the claims made. When representations or marketing practices are targeted to a specific audience, such as the elderly or the financially unsophisticated, the standard is based upon the effects of the act or practice on a reasonable member of that group.

If a representation conveys two or more meanings to reasonable consumers and one meaning is misleading, the representation may be deceptive. Moreover, a consumer's interpretation or reaction may indicate that an act or practice is deceptive under the circumstances, even if the consumer's interpretation is not shared by a majority of the consumers in the relevant class, so long as a significant minority of such consumers is misled.

In evaluating whether a representation, omission or practice is deceptive, the Agencies will look at the entire advertisement, transaction, or course of dealing to determine how a reasonable consumer would respond. Written disclosures may be insufficient to correct a misleading statement or representation, particularly where the consumer is directed away from qualifying limitations in the text or is counseled

that reading the disclosures is unnecessary. Likewise, oral disclosures or fine print may be insufficient to cure a misleading headline or prominent written representation.

- The representation, omission, or practice must be material.

A representation, omission, or practice is material if it is likely to affect a consumer's decision regarding a product or service. In general, information about costs, benefits, or restrictions on the use or availability of a product or service is material. When express claims are made with respect to a financial product or service, the claims will be presumed to be material. Similarly, the materiality of an implied claim will be presumed when it is demonstrated that the institution intended that the consumer draw certain conclusions based upon the claim.

Claims made with the knowledge that they are false will also be presumed to be material. Omissions will be presumed to be material when the financial institution knew or should have known that the consumer needed the omitted information to evaluate the product or service.

### **Relationship to Other Laws**

Acts or practices that are unfair or deceptive within the meaning of section 5 of the FTC Act may also violate other federal or state statutes. On the other hand, there may be circumstances in which an act or practice violates section 5 of the FTC Act even though the institution is in technical compliance with other applicable laws, such as consumer protection and fair lending laws. Banks should be mindful of both possibilities. The following laws warrant particular attention in this regard:

#### ***Truth in Lending and Truth in Savings Acts***

Pursuant to the Truth in Lending Act (TILA), creditors must "clearly and conspicuously" disclose the costs and terms of credit. The Truth in Savings Act (TISA) requires depository institutions to provide interest and fee disclosures for deposit accounts so that consumers may compare deposit products. TISA also provides that advertisements shall not be misleading or inaccurate, and cannot misrepresent an institution's deposit contract. An act or practice that does not comply with these provisions of TILA or TISA may also violate the FTC Act. On the other hand, a transaction that is in technical compliance with TILA or TISA may nevertheless violate the FTC Act. For example, consumers could be misled by advertisements of "guaranteed" or "lifetime" interest rates when the creditor or depository institution intends to change the rates, whether or not the disclosures satisfy the technical requirements of TILA or TISA.

#### ***Equal Credit Opportunity and Fair Housing Acts***

The Equal Credit Opportunity Act (ECOA) prohibits discrimination in any aspect of a credit transaction against persons on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to contract), the fact that an applicant's income derives from any public assistance program, and the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act. Similarly, the Fair Housing Act (FHA) prohibits creditors involved in residential real estate transactions from discriminating against any person on the basis of race, color, religion, sex, handicap, familial status, or national origin. Unfair or deceptive practices that target or have a disparate impact on consumers who are members of these protected classes may violate the ECOA or the FHA, as well as the FTC Act.

#### ***Fair Debt Collection Practices Act***

The Fair Debt Collection Practices Act prohibits unfair, deceptive, and abusive practices related to the collection of consumer debts. Although this statute does not by its terms apply to banks that collect their own debts, failure to adhere to the standards set by this Act may support a claim of unfair or deceptive practices in violation of the FTC Act. Moreover, banks that either affirmatively or through lack of oversight, permit a third-party debt collector acting on their behalf to engage in deception, harassment, or threats in the collection of monies due may be exposed to liability for approving or assisting in an unfair or deceptive act or practice.

## ***Managing Risks Related to Unfair or Deceptive Acts or Practices***

Since the release of the FDIC's statement and the Board's letter on unfair and deceptive practices in May 2002, bankers have asked for guidance on strategies for managing risk in this area. This section outlines guidance on best practices to address some areas with the greatest potential for unfair or deceptive acts and practices, including: advertising and solicitation; servicing and collections; and the management and monitoring of employees and third-party service providers. Banks also should monitor compliance with their own policies in these areas, and should have procedures for receiving and addressing consumer complaints and monitoring activities performed by third parties on behalf of the bank.

To avoid engaging in unfair or deceptive activity, the Agencies encourage use of the following practices, which have already been adopted by many institutions:

Review all promotional materials, marketing scripts, and customer agreements and disclosures to ensure that they fairly and adequately describe the terms, benefits, and material limitations of the product or service being offered, including any related or optional products or services, and that they do not misrepresent such terms either affirmatively or by omission. Ensure that these materials do not use fine print, separate statements or inconspicuous disclosures to correct potentially misleading headlines, and ensure that there is a reasonable factual basis for all representations made.

Draw the attention of customers to key terms, including limitations and conditions, that are important in enabling the customer to make an informed decision regarding whether the product or service meets the customer's needs.

Clearly disclose all material limitations or conditions on the terms or availability of products or services, such as a limitation that applies a special interest rate only to balance transfers; the expiration date for terms that apply only during an introductory period; material prerequisites for obtaining particular products, services or terms (e.g., minimum transaction amounts, introductory or other fees, or other qualifications); or conditions for canceling a service without charge when the service is offered on a free trial basis.

Inform consumers in a clear and timely manner about any fees, penalties, or other charges (including charges for any force-placed products) that have been imposed, and the reasons for their imposition.

Clearly inform customers of contract provisions that permit a change in the terms and conditions of an agreement.

When using terms such as "pre-approved" or "guaranteed," clearly disclose any limitations, conditions, or restrictions on the offer.

Clearly inform consumers when the account terms approved by the bank for the consumer are less favorable than the advertised terms or terms previously disclosed.

Tailor advertisements, promotional materials, disclosures and scripts to take account of the sophistication and experience of the target audience. Do not make claims, representations or statements that mislead members of the target audience about the cost, value, availability, cost savings, benefits, or terms of the product or service.

Avoid advertising that a particular service will be provided in connection with an account if the bank does not intend or is not able to provide the service to accountholders. Clearly disclose when optional products and services — such as insurance, travel services, credit protection, and consumer report update services that are offered simultaneously with credit — are not required to obtain credit or considered in decisions to grant credit.

Ensure that costs and benefits of optional or related products and services are not misrepresented or presented in an incomplete manner.



When making claims about amounts of credit available to consumers, accurately and completely represent the amount of potential, approved, or useable credit that the consumer will receive.

Avoid advertising terms that are not available to most customers and using unrepresentative examples in advertising, marketing, and promotional materials.

Avoid making representations to consumers that they may pay less than the minimum amount due required by the account terms without adequately disclosing any late fees, overlimit fees, or other account fees that will result from the consumer paying such reduced amount.

Clearly disclose a telephone number or mailing address (and, as an addition, an email or website address if available) that consumers may use to contact the bank or its third-party servicers regarding any complaints they may have, and maintain appropriate procedures for resolving complaints. Consumer complaints should also be reviewed by banks to identify practices that have the potential to be misleading to customers.

Implement and maintain effective risk and supervisory controls to select and manage third-party servicers.

Ensure that employees and third parties who market or promote bank products, or service loans, are adequately trained to avoid making statements or taking actions that might be unfair or deceptive.

Review compensation arrangements for bank employees as well as third-party vendors and servicers to ensure that they do not create unintended incentives to engage in unfair or deceptive practices.

Ensure that the institution and its third party servicers have and follow procedures to credit consumer payments in a timely manner. Consumers should be clearly told when and if monthly payments are applied to fees, penalties, or other charges before being applied to regular principal and interest.

The need for clear and accurate disclosures that are sensitive to the sophistication of the target audience is heightened for products and services that have been associated with abusive practices. Accordingly, banks should take particular care in marketing credit and other products and services to the elderly, the financially vulnerable, and customers who are not financially sophisticated. In addition, creditors should pay particular attention to ensure that disclosures are clear and accurate with respect to: the points and other charges that will be financed as part of home-secured loans; the terms and conditions related to insurance offered in connection with loans; loans covered by the Home Ownership and Equity Protection Act; reverse mortgages; credit cards designed to rehabilitate the credit position of the cardholder; and loans with pre-payment penalties, temporary introductory terms, or terms that are not available as advertised to all consumers.

## **Conclusion**

The development and implementation of policies and procedures in these areas and the other steps outlined above will help banks assure that products and services are provided in a manner that is fair, allows informed customer choice, and is consistent with the FTC Act.

Last Updated 3/11/2004

[communications@fdic.gov](mailto:communications@fdic.gov)

---

[Home](#) [Contact Us](#) [Search](#) [Help](#) [SiteMap](#) [Forms](#)  
[Freedom of Information Act](#) [Website Policies](#) [FirstGov.gov](#)



## Financial Institution Letters

---

[Federal Register: March 17, 2004 (Volume 69, Number 52)]

[Proposed Rules]

[Page 12571-12580]

From the Federal Register Online via GPO Access [[wais.access.gpo.gov](http://wais.access.gpo.gov)]

[DOCID:fr17mr04-14]

=====

Proposed Rules

Federal Register

---

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

=====

[[Page 12571]]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Parts 303 and 324

RIN 3064-AC78

Filing Procedures; Transactions With Affiliates

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Notice of proposed rulemaking.

-----

SUMMARY: Insured State nonmember banks are subject to the restrictions and limitations on transactions by member banks with affiliates found in sections 23A and 23B of the Federal Reserve Act "in the same manner and to the same extent" as though they were member banks. The Board of Governors of the Federal Reserve System (FRB) adopted 12 CFR 223 ("Regulation W") governing sections 23A and 23B. The FDIC is proposing to add a new part to title 12 of the CFR that would cross reference Regulation W to make it clear that insured State nonmember banks are subject to the restrictions and limitations, and may take

advantage of the exemptions, contained in Regulation W. FDIC's regulation would also make it clear that the FDIC administers the restrictions and limitations contained in Regulation W as to insured State nonmember banks, may grant case-by-case exemptions from those restrictions and limitations, and is the appropriate agency to make other determinations under Regulation W. The proposal would also amend part 303 of FDIC's regulations governing filing and hearing procedures by adding a new section that would govern requests for exemptions from new part 324 and hearings that are held for the purpose determining whether a shareholder or company exercises a controlling influence over another company.

**DATES:** Written comments must be received on or before May 3, 2004.

**ADDRESSES:** You may submit comments, identified by RIN number by any of the following methods:

Agency Web Site: <http://www.fdic.gov/regulations/laws/federal/propose.html>.  
Follow instructions for

submitting comments on the Agency Web site.

E-mail: [Comments@FDIC.gov](mailto:Comments@FDIC.gov). Include the RIN number in the subject line of the message.

Mail: Robert E. Feldman, Executive Secretary,  
Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

Hand Delivery/Courier: Guard station at rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

Instructions: All submissions received must include the agency name and RIN for this rulemaking. All comments received will be posted without change to <http://www.fdic.gov/regulations/laws/federal/propose.html> including any personal information provided.

**FOR FURTHER INFORMATION CONTACT:** Curtis Vaughn, Senior Examination Specialist, Division of Supervision and Consumer Protection, (202) 898-6759 or [cvaughn@fdic.gov](mailto:cvaughn@fdic.gov), Kenyon T. Kilber, Senior Examination Specialist, Division of Supervision and Consumer Protection, (202) 898-8935 or [kkilber@fdic.gov](mailto:kkilber@fdic.gov) or Pamela E.F. LeCren, Counsel, Legal Division, (202) 898-3730 or [plecren@fdic.gov](mailto:plecren@fdic.gov), Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

#### **SUPPLEMENTARY INFORMATION:**

##### **Background**

Section 18(j)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1828(j)(1) ("FDI Act") provides that "Sections 371c and 371c-1 of [title 12] shall apply with respect to every nonmember insured bank in the same manner and to the same extent as if the nonmember insured bank were a member bank." Sections 371c and 371c-1 of title 12 (12 U.S.C. 371c, 371c-1) are respectively sections 23A and 23B of the Federal Reserve Act (FRA). They establish restrictions and limitations with respect to transactions between member banks and their affiliates. The purpose of those restrictions is to protect member banks from suffering losses when entering into transactions with affiliates.

Section 23A (1) establishes limits on the amount of "covered transactions" between a member bank and its affiliates (any one affiliate and in the aggregate as to all affiliates); (2) requires that all covered transactions between a member bank and its affiliates be on terms and conditions that are consistent with safe and sound banking

practices; (3) prohibits the purchase of low quality assets from an affiliate; and (4) requires that extensions of credit by a member bank to an affiliate, and guarantees on behalf of affiliates, be secured by statutorily defined amounts of collateral. Section 23B (1) requires that transactions (covered transactions as well as other identified transactions such as the sale of assets to an affiliate) between a member bank and its affiliates be on market terms (on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with nonaffiliates); (2) prohibits purchases of assets from an affiliate as fiduciary unless one of several exceptions are met; (3) prohibits purchases of securities during the existence of an underwriting or selling syndicate if the principal underwriter of the securities is an affiliate; and (4) prohibits any advertisements or agreements by a member bank suggesting that the bank is responsible for the obligations of an affiliate.

The FDIC interprets and enforces the restrictions and requirements of sections 23A and 23B of the FRA as to FDIC insured State banks that are not members of the Federal Reserve System (insured State nonmember banks) and has done so for many years. Until recently neither the FRB nor the FDIC had adopted, or proposed, a regulation on the restrictions of sections 23A or 23B as applicable to the depository institutions over which each is given responsibility under the FRA and FDI Act respectively. Both agencies relied, rather, upon the language of the FRA and careful coordination of their interpretations of the statutory restrictions. On May 11, 2001, the FRB published a proposed regulation (Regulation W) designed to implement sections 23A and 23B of the FRA if that proposal were adopted in final. (66 FR 24186). The FDIC filed a formal comment on the proposal. On December 12, 2002, the FRB published Regulation W as a final rule. (67 FR 76560). It became effective on April 1, 2003, and is codified at 12 CFR 223. The preamble accompanying Regulation W as adopted in final form indicated that member

[[Page 12572]]

banks would be given certain time periods to bring outstanding transactions into compliance with the new regulation.

Regulation W defines terms; restates the statutory prohibitions found in section 23A and 23B; establishes a number of exemptions to those restrictions; explains how to value credit transactions and asset purchases for purposes of complying with the limits on covered transactions; sets out rules on when covered transactions arise for purposes of Regulation W; sets out rules with respect to derivative transactions and how section 23A and 23B apply to foreign branches; defines the term "financial subsidiary" for purposes of Regulation W; and sets out the standards under which the FRB will grant requests for exemptions on a case-by-case basis.

In keeping with section 18(j)(1) of the FDI Act, the FDIC is proposing to add a new part to title 12 of the CFR. The purpose of this new part is to make clear that insured State nonmember banks must comply with the restrictions and limitations contained in Regulation W in order to comply with sections 23A and 23B of the FRA and section 18(j)(1) of the FDI Act. As previously stated, section 18(j)(1) of the FDI Act provides that sections 23A and 23B shall apply to insured State nonmember banks "in the same manner and to the same extent" as if the nonmember banks are member banks. This requirement in the FDI Act means that the substantive requirements and restrictions set out in Regulation W apply equally to insured State nonmember banks. The FDIC has taken those requirements and restrictions into consideration in interpreting and applying sections 23A and 23B to insured State nonmember banks since the adoption of Regulation W. The FDIC is now

proposing to add part 324, which will expressly incorporate through cross reference the substantive provisions of Regulation W. The part also identifies the FDIC as the appropriate agency for State nonmember banks in the administration and interpretation of those requirements and in granting exemption requests.

## Discussion

### Description of Proposal

Proposed part 324 is divided into six sections. Section 324.1 sets out the authority under which the FDIC is proposing to act and describes the purpose and scope of the regulation. Section 324.2 provides that the restrictions and limitations of Regulation W apply to insured State nonmember banks and contains an exemption for certain subsidiary relationships that were entered into prior to the date on which the FDIC's proposed part was published for public comment. Section 324.3 informs insured State banks that they are to follow the FDIC's procedures set forth in part 303 of the FDIC's regulations when requesting a hearing or making any filing under part 324. Section 324.4 makes it clear that "member bank" should be read as "insured State nonmember bank", "Board" should be read as "FDIC" and "appropriate Federal banking agency" should be understood to mean "FDIC" wherever those terms appear in Regulation W. Section 324.4 also contains a definition of "State nonmember bank". Section 324.5 provides that insured State nonmember banks may obtain an exemption from the restrictions and limitations of this part concerning section 23A if the FDIC determines that such an exemption is in the public interest and is consistent with the purposes of section 23A. Procedures for filing exemption requests are proposed in this section and would, if adopted, be added to part 303 of FDIC's regulations (Filing Procedures) as new Sec. 303.251. Finally, Sec. 324.6 provides that determinations that a shareholder or company exercises a controlling influence over another company will only be made after notice and opportunity for hearing. Hearings would be conducted in accordance with the proposed amendments to part 303 that are set out as part of this rulemaking. Proposed part 324, and the accompanying proposed amendments to part 303, are discussed in more detail below.

### Section 324.1 Authority, Purpose and Scope

The FDIC derives the authority from section 9 (Tenth) of the FDI Act (12 U.S.C. 1819 (Tenth)) to adopt rules implementing sections 23A and 23B of the FRA as made applicable to insured State nonmember banks. Section 9 (Tenth) of the FDI Act authorizes the FDIC to issue rules and regulations "to carry out the provisions of this chapter or of any other law which it has the responsibility of administering or enforcing".

The FDIC has the responsibility of administering and enforcing section 18(j)(1) of the FDI Act as to state nonmember banks. The language in section 9 (Tenth) of the FDI Act limits the FDIC's authority to adopt regulations governing a particular area only if "authority to issue such rules and regulations has been expressly and exclusively granted to any other regulatory agency". Nothing in the text of section 23A or section 23B or the legislative history of those sections indicates that the FRB has the "exclusive" rulemaking authority with respect to those sections as they apply to institutions other than member banks.\1\

---

\1\ Congress could have amended the FRA to refer to "bank"

rather than "member bank" if it wanted to provide the FRB with exclusive rulemaking authority with regard to sections 23A and 23B but it did not do so. Instead Congress amended the FDI Act, not once but twice, by incorporating a cross reference first to section 23A and then to section 23B after that section was added to the FRA. The fact that Congress chose to amend the FDI Act and not the FRA signals an intent to provide the FDIC with a role in the administration and interpretation of sections 23A and 23B.

-----

The text of sections 23A and 23B itself bear out the proposition that the FDIC is free to adopt regulations in this area. Sections 23A and 23B do not parcel out responsibility between the FRB and the appropriate Federal banking agencies as is the case with sections 22(g) and 22(h) of the FRA, both of which are also made applicable to insured State nonmember banks by section 18(j) of the FDI Act "in the same manner and to the same extent" as though they were member banks. Section 23A and 23B's silence with respect to what role the other Federal banking agencies are to play shows that the FRA does not operate as a constraint on the authority the FDIC derives from its own statute to establish rules implementing section 23A and 23B and the FDIC's ability to make decisions in applying those sections to insured State nonmember banks. The only restraint placed on the FDIC by the FDI Act is that all of the restrictions and limitations of section 23A and 23B be applied "in the same manner and to the same extent" as those restrictions and limitations are applied to member banks. As discussed below, the FDIC will in fact be applying Regulation W and section 23A and 23B to State nonmember banks in the same way as those provisions apply to member banks.

#### Section 324.2 Affiliate Transactions

General Requirements--Paragraph (a) of Sec. 324.2 of the proposal cross references Regulation W and restates the requirement found in section 18(j)(1) of the FDI Act that sections 23A and 23B of the FRA apply to insured State nonmember banks as though they were member banks. The purpose of paragraph (a) is to clarify that insured State nonmember banks must comply with the substantive provisions of Regulation W in order to comply with section 18(j)(1) of the FDI Act and part

[[Page 12573]]

324. The effect going forward of the cross reference in Sec. 324.2(a) to Regulation W is that State nonmember banks will automatically be subject to any changes made to Regulation W by the FRB without the need for the FDIC to take any action to amend its own regulation.

Exception to General Requirements--The FDIC is proposing to adopt a regulatory exemption to the general rule set out in paragraph (a) of Sec. 324.2 of the proposal that insured State nonmember banks are subject to the restrictions and requirements of Regulation W.<sup>12\</sup> Paragraph (b) of Sec. 324.2 would exempt from the restrictions of part 324 certain subsidiary relationships that were established prior to the date on which the FDIC's proposal is published for comment. If a subsidiary relationship predates that date and that subsidiary relationship was not considered by the FDIC to be subject to section 23A and 23B prior to December 12, 2002 (i.e., the subsidiary was not considered to be an affiliate for purposes of section 23A and 23B as it was interpreted and applied by the FDIC) but is subject to section 23A and 23B after that date (is considered an affiliate relationship under Regulation W) the subsidiary will not be treated as an affiliate for

purposes of part 324. Under the exemption, the bank's investment in the company, and its other covered transactions, if any, with the company, will not count toward the quantitative amount limitations that would otherwise apply under part 324 and outstanding transactions with the company do not need to be brought into compliance with part 324. It also means that, going forward, the bank is not subject to the restrictions of part 324 whenever it deals with that subsidiary company, e.g., any future extensions of credit to, or investments in, the subsidiary will not count toward the limits on covered transactions with affiliates to which the bank is subject. The exemption only applies, however, for so long as the subsidiary's activities are limited to those that were approved by the FDIC by regulation or order, or which are covered by an exception in section 24 of the FDI Act (12 U.S.C. 1831a) ("section 24"), and were conducted as of the date on which the FDIC's proposal is published for comment. If, for example, the subsidiary changes its line of business in such a way that under Regulation W a newly established subsidiary of the bank doing the same thing would be considered an affiliate, the subsidiary will be treated as an affiliate from that point forward. The effect of the loss of the exemption is that, going forward, covered transactions between the bank and the subsidiary will be subject to part 324. Although the exemption would no longer apply, the outstanding investment in the subsidiary, any outstanding extensions of credit to the subsidiary and any other prior transactions with the subsidiary would not be affected by the loss of the exemption.

---

\2\ The FDIC has the authority to adopt by regulation or order exemptions from the restrictions of section 23A if the FDIC determines that the exemption is in the public interest and is consistent with the purposes of the section 23A of the FRA.

---

The exemption provided for under the proposal is intended to cover several categories of subsidiaries. The first category is those subsidiaries that, prior to the date on which the FDIC's proposal was issued for comment, were established after the FDIC issued an approval order under section 24 of the FDI Act and 12 CFR 362 ("section 24 subsidiaries"). Such subsidiaries are by definition engaged in activities that are not permissible for a subsidiary of a national bank. The exemption is not limited, however, to State nonmember banks that applied for and obtained consent to establish a subsidiary under 12 CFR 362. It also covers section 24 subsidiaries that were established prior to the date on which the FDIC's proposal was published for comment that were (1) established after filing a notice under part 362,\3\ or (2) established pursuant to a provision of part 362 that permits State nonmember banks to establish certain subsidiaries without filing notice or making application to the FDIC.\4\ Finally, the exemption also is intended to cover subsidiaries established prior to the relevant date pursuant to a statutory exception in section 24 of the FDI Act which is restated in 12 CFR 362.

---

\3\ 12 CFR 362 permits state nonmember banks to establish certain subsidiaries after filing a notice with the FDIC provided that certain conditions and requirements are met. In each such instance the conditions include affiliate transaction restrictions.

\4\ 12 CFR 362 permits an insured state nonmember bank to establish a subsidiary that invests in bank stock (Sec. 362.4(b)(4)(ii)); engages in certain leasing activities (Sec. 362.4(b)(6)); invests in adjustable rate preferred stock, money



market preferred stock and similar instruments (Sec. 362.4(b)(7)); and holds a control interest in a company that engages in insurance agency activities, any national bank permissible activity, real estate leasing, or that invests in adjustable rate and money market preferred stock (Sec. 362.4(b)(3)(ii)) without filing an application or a notice.

---

As proposed, the subsidiary relationship exemption may be over inclusive to the extent that some of the section 24 subsidiaries described above fall within an exception to the definition of financial subsidiary found in Regulation W and thus are not considered to be affiliates. As it may be possible to construe the exceptions to the definition of financial subsidiary found in Regulation W narrowly, the FDIC has opted to draft the proposed exemption broadly so as to avoid any undue confusion or ambiguity as to how insured State nonmember banks with existing section 24 subsidiaries are affected by the adoption of FRB Regulation W.

The FDIC intends to limit the exemption to the types of section 24 subsidiaries described above. Comment is invited on whether the regulatory text is sufficiently clear as to its scope or has broader effect than intended. In addition, comment is requested on whether the FDIC should consider narrowing the scope of the exemption or making it broader.

It has been the FDIC's practice to include in section 24 approval orders conditions on the manner and extent to which an insured State nonmember bank may interact with its subsidiary that engages in activities that are not permissible for a subsidiary of a national bank.<sup>15</sup> Those conditions are very similar but not identical to the restrictions found in section 23A and 23B and Regulation W. In addition, the FDIC's regulations which provide that a bank may simply file a notice before establishing a certain type of subsidiary require in most instances that a bank must abide by certain affiliate transaction restrictions when interacting with the subsidiary if a bank wants to take advantage of the notice procedure. The affiliate transaction restrictions that apply in the case of a notice are the same restrictions which have been imposed by the FDIC by order on a case-by-case basis. Banks that are eligible for the subsidiary relationship exemption but which are subject by order or regulation to conditions placing restrictions on the bank's transactions with its subsidiary would still be subject to those conditions (i.e., the proposed exemption would not supercede or invalidate those conditions).

---

<sup>15</sup> Section 24 of the FDI Act requires the FDIC to determine that the activities to be engaged in by the subsidiary do not present a significant risk to the fund. The FDIC can, and typically has, determined that a particular activity does not present a significant risk to the fund provided that the activity is conditioned in such a way as to make any risk associated with the conduct of that activity by the subsidiary acceptable.

---

As indicated above, the FDIC may, by regulation or order, exempt transactions or relationships from the requirements and restrictions of sections 23A and 23B of the FRA if the FDIC finds that the exemption is in the public interest and consistent with the purposes of the

[[Page 12574]]

FRA. The proposed subsidiary relationship exemption should not have an

adverse impact on the public interest or be inconsistent with the purposes of section 23A and 23B as most banks that have subsidiaries that are eligible for the exemption are already subject to affiliate transaction conditions very similar to those found in Regulation. The exemption would not affect those conditions. The majority of the section 24 subsidiaries which have been approved by the FDIC involved either real estate subsidiaries or subsidiaries that invest in equity securities.<sup>16\</sup> The majority of the real estate subsidiaries are subject to affiliate transaction restrictions similar to those found in Regulation W and many of those that are not subject to such restrictions are approvals to hold certain real estate investments pending their liquidation. The FDIC carefully reviewed the requests for consent to engage in equity securities investments through a subsidiary. Although many of the equity securities applications were not made subject to affiliate transaction restrictions, the applications that were approved were made subject to whatever conditions the Board found necessary in its best judgment to protect the deposit insurance funds from risk given the facts and circumstances of each application. (Section 24 requires the FDIC to determine that the conduct of business by subsidiaries such as these does not present a significant risk before the FDIC may give its consent to acquisition or establishment of the subsidiary.) The majority of the equity subsidiaries that were approved involved small investments (less than 10% of tier one capital) and in many cases the equities in which those subsidiaries sought consent to invest were bank holding companies and other similar firms. Most of the approvals were conditioned in such a way as to limit lending to the subsidiaries and to limit the amount of the investments that the subsidiaries may in turn make. Given the Board's initial review and determination and the conditions to which the approvals are subject, the FDIC does not believe that grandfathering these subsidiaries will be contrary to the public interest. What is more, the FDIC notes that these equity investment securities are in many ways similar to private equity funds (the vehicle through which financial holding companies may invest in equity securities) which are provided special treatment under Regulation W.

---

<sup>16\</sup> A summary of requests approved by the FDIC's Board of Directors can be viewed at <http://www.fdic.gov/regulations/resources/approved/index.html>

---

Section 324.2(b) of the proposal does not exempt transactions entered into by a State nonmember bank prior to the publication date of the proposal from compliance with Regulation W and part 324. All transactions with affiliates, regardless of when entered into, are governed by Regulation W and the phase-in periods adopted by the FRB in the case of member banks. Transactions entered into after December 12, 2002, but before April 1, 2003, by member banks with their affiliates were required to comply with Regulation W as of April 1, 2003. Transactions entered into prior to December 12, 2002, were required to comply with Regulation W no later than July 1, 2003. State nonmember banks that entered into transactions with affiliates that would have been required to be in compliance with Regulation W by either April 1, 2003, or July 1, 2003, if entered into by a member bank and which are not in compliance at this time will be cited for a violation of section 23A and 23B and section 18(j)(1) of the FDI Act as appropriate. Comment is invited as to whether the FDIC should consider adopting some other treatment in part 324. For example, should the FDIC grant an additional compliance period or perhaps grandfather pre-existing transactions?

### Section 324.3 Submissions and Requests for Hearing

Section 324.3 informs insured State nonmember banks that all filings, submissions, requests for hearings and other requests made under this part are to be made in accordance with the procedures set out in 12 CFR 303. The intent of the provision is to eliminate any confusion that might arise as to the procedures to be followed by insured State nonmember banks (procedures found in Regulation W or elsewhere in FRB regulations or procedures found in the FDIC's regulations which might differ from those used by the FRB). This rulemaking would add a new Sec. 303.251 to 12 CFR 303 that would set out the applicable procedures for submissions, filings, and requests for hearing that are made under Sec. Sec. 324.5 and 324.6 of the proposal. The proposed procedures are discussed in more detail below.

### Section 324.4 Definitions and Usage of Terms

Section 324.4 of the proposal substitutes appropriate terminology for that found in Regulation W to make it clear that, for the purposes of compliance with section 18(j)(1) of the FDI Act and this part, "member bank" should be understood to mean "insured State nonmember bank"; "Board" should be understood to mean "FDIC"; and "appropriate Federal banking agency" should be understood to mean "FDIC" wherever those words or phrases are used in Regulation W. The section also defines "State nonmember bank" by cross referencing the definition found in section 3 of the FDI Act (12 U.S.C. 1813(e)).

Sections 324.2(a), 324.3 and 324.4 together accomplish two important things. They make clear that (1) the FDIC, as the Federal supervisor of insured State nonmember banks, is the appropriate party to whom insured State nonmember banks must look for guidance in interpreting the requirements of sections 23A and 23B of the FRA as they apply to insured State nonmember banks through section 18(j) of the FDI Act, and (2) it is the FDIC which exercises discretion in applying the restrictions and limitations found in Regulation W in those instances in which Regulation W provides for relief, calls for determinations, or provides for the exercise of discretion by the FRB. In short, by adopting the cross reference to Regulation W the FDIC is satisfying its obligation to ensure that insured State nonmember banks are subject to sections 23A and 23B as though they were member banks. It is only appropriate, and is in fact necessary to the effective accomplishment of the FDIC's charge to oversee the safety and soundness of insured State nonmember banks, for the FDIC to exercise the authority to make decisions with respect to particular insured State nonmember banks and their transactions with affiliates in the context of the overall facts and circumstances affecting those banks. The FDIC is the supervisor of these particular institutions and the Federal supervisory agency that is in the best position to evaluate the need for relief.

As indicated above, part 324 makes it clear that the reference to the "appropriate Federal banking agency" as found in Regulation W means the FDIC. References to the FDIC in FDIC's regulations will normally be understood to refer to the FDIC's Board of Directors unless the Board of Directors has delegated the matter to some other individual within the agency. Regulation W contains several provisions that permit the "appropriate Federal Banking agency" to make certain decisions. For example, section 223.15(b)(3) of Regulation W provides that the appropriate Federal banking agency may set the amount by which a bank's share of a participation in a loan originated by an affiliate which is now a problem loan and which is being

renewed (or for which additional funds are extended) may exceed 5% of the bank's original exposure without the renewal constituting a purchase of a low quality asset. Insured State nonmember banks should note that it is the FDIC's present intent that the authority to make determinations under Regulation W that are to be made by the "appropriate Federal banking agency" will be delegated to the Director of the Division of Supervision and Consumer Protection and the Director's designee.

#### Section 324.5 Exemption Requests

Section 223.43 of Regulation W (12 CFR 223.43) provides that the FRB may, by regulation or order, at its discretion, exempt transactions or relationships from the requirements of section 23A if the FRB determines that the exemption is in the public interest and is consistent with the purposes of section 23A. FDIC's proposed Sec. 324.5 provides that insured State nonmember banks may request an exemption from the requirements and restrictions of section of 23A, as implemented by Regulation W, by filing a written request with the FDIC. The FDIC may, in its discretion, grant an exemption if the FDIC determines that it is in the public interest to do so and the FDIC determines that granting the exemption is consistent with the purposes of section 23A. This provision is similar in purpose to Sec. Sec. 324.2, 324.3 and 324.4 in that it makes clear that it is the FDIC which is the appropriate agency to grant relief in the case of an insured State nonmember bank.

Exemptions from the restrictions of Regulation W are available for insured State nonmember banks under the same standards that apply to member banks, i.e., if the exemption is in the public interest and it is consistent with the purposes of section 23A. Exemptions are thus available to member and nonmember banks "in the same manner" (after filing a request for an exemption) and "to the same extent" (after the bank's request is evaluated based upon the same standards). The only difference is that it is the FDIC which, based on its unique supervisory perspective and familiarity with the institution in question, evaluates whether those standards are met and whether it is appropriate to grant an exemption.

Past practice has been for insured State nonmember banks to apply to the FRB to obtain exemptions from the restrictions of section 23A. Usually the FRB consults with the FDIC prior to granting exemptions. Absent unusual circumstances, if the FDIC objects to the exemption request, it is not granted. Rather than continue the practice of allowing insured State nonmember banks to file exemption requests with the FRB, the FDIC is proposing to instruct insured State nonmember banks to file all exemption requests with the FDIC. Since FDIC is the primary Federal banking supervisor of insured State nonmember banks and is more familiar with the condition and overall management of those banks than the FRB, it is more appropriate for the FDIC to review and act on exemption requests from insured State nonmember banks. It is not only more appropriate to do so, but the FDIC expects that following this new procedure will result in more efficiency in the review of the requests which will in turn benefit banks. We anticipate that individual reviews will take less time even though it is the FDIC's intent to continue to coordinate with the FRB to ensure that the standards under which exemption requests are evaluated are consistently applied by the FDIC and the FRB. If adopted, the regulation would not have any effect on exemptions previously granted by the FRB. Those exemptions will continue to be valid and there would be no need for an insured State nonmember bank to seek an order from the FDIC affirming

the prior exemption granted by the FRB.

Procedures for filing exemption requests are proposed for comment and are discussed below under the heading "Section 303.251 Affiliate Transactions". If adopted, those procedures would be set out in a new Sec. 303.251.

#### Section 324.6 Controlling Influence Determinations

Section 23A of the FRA requires a shareholder or a company to be given notice and opportunity for a hearing before the shareholder or company is determined to directly or indirectly exercise a controlling influence over the management or policies of another company. The impact of a determination that such influence is found to exist is that the shareholder or company is considered to control the other company, thus making the companies affiliates for the purposes of section 23A.

Section 324.6 of the proposed regulation restates the statutory obligation for opportunity for a hearing prior to the control determination being made. It also makes it clear that the FDIC and not the FRB is the agency that affords the opportunity for a hearing and makes the final determination on the control issue when an insured State nonmember bank is involved. (See, *Roque De La Fuente II v. FDIC*, 332 F.3d 1208 (9th Cir. 2003) (FDIC has the authority and obligation to afford opportunity for hearing and to conduct a control hearing). The standard under the proposal for determining if control exists is whether the shareholder or company has a controlling influence over the management or policies of the other company. This standard is identical to that found in section 23A of the FRA and is the same standard in FRB Regulation W.<sup>17</sup>

-----

<sup>17</sup> The FDIC recognizes that it will be necessary to coordinate with the FRB to assure consistency as between the application of the standard to member banks and state nonmember banks. We note, however, that to date the FRB has never had a control hearing under the relevant provisions of section 23A of the FRA. At this time there is no existing prior FRB precedent resulting from a control hearing for the FDIC to take into consideration.

-----

If a hearing is requested by an insured State nonmember bank, or one of its shareholders, the hearing will be conducted in accordance with the procedures set out in 12 CFR 303. (See discussion below under the heading "Section 303.251 Affiliate transactions" for information regarding the hearing procedures that are proposed for comment.)

#### Proposed Amendments to 12 CFR 303

##### Section 303.251 Affiliate Transactions

FDIC is proposing to amend part 303 governing filing procedures and certain hearings. Under the proposal, a new section would be added to subpart M-- "Other Filings" that would (1) set out the procedures for filing a request for an exemption from section 23A, and (2) set out the procedures governing hearings to determine whether or not a shareholder or company exercises a controlling influence over another company.

Exemption requests--As proposed in Sec. 303.251(a), the procedures governing requests for an exemption from the restrictions of section 23A would require the requesting bank to file a letter with the appropriate FDIC office that (1) describes in detail the relationship or transaction for which the bank is seeking an exemption, (2) identifies the requirements or restrictions from which the bank is

seeking relief, and (3) sets out an explanation of why the exemption is in the public interest and is consistent with the purposes of section 23A. The FDIC may request any additional information that is, in its opinion, necessary to properly evaluate the request. Banks that file exemption requests will receive written notification of the FDIC's decision. The proposed exemption procedures are substantially

[[Page 12576]]

the same as those adopted by the FRB in Regulation W for member banks with the exception that, unlike member banks, State nonmember banks would file requests with an FDIC regional office rather than with the agency's General Counsel. At the present time it is anticipated that the FDIC's Board of Directors will retain the authority to grant exemptions and will not delegate that responsibility.

Controlling influence hearing requests--Procedures governing requests for hearings and the actual conduct of hearings to determine control are set out in proposed Sec. 303.251(b). Under the proposed procedures the FDIC is required to provide a shareholder or company written notice of an opportunity for hearing before the agency makes a determination that there is an affiliation based on the ability to exercise a controlling influence over the management or policies of another company. A company or shareholder that wants a hearing must respond to that effect no later than 10 days after receiving the written notice of opportunity for hearing by filing a request for a hearing with the "appropriate FDIC office" as that term is defined in 12 CFR 303. Which FDIC office is the "appropriate FDIC office" is dependent upon whether the institution that is the subject of a filing is not part of a group of related institutions. If that is the case, the appropriate regional office for that institution, and any individual associated with the institution, is the FDIC region in which the institution is located. (See Sec. 303.2(g)(1) of current part 303). If the institution that is the subject of a filing is part of a group of related institutions, the appropriate FDIC regional office for that institution, and any individual associated with that institution, is the FDIC region in which the group's major policy and decision makers are located (or any other region the FDIC designates on a case-by-case basis). (See Sec. 303.2(g)(2) of current part 303).

Requests for a control hearing will be acknowledged in writing. The date and time for hearings will be set by the FDIC solely in its discretion ("such time as FDIC determines to be reasonable"). In setting the date for the hearing the FDIC will take care to consider the convenience of the participants in addition to other factors such as the complexity of the issues and the potential effects of the timing of the hearing on associated matters such as a pending examination. The presiding officer will be the Director of the Division of Supervision and Consumer Protection or the Director's designee. The presiding officer is responsible for conducting the hearing, determining any procedural question that is not specifically addressed by Sec. 303.251(b), and rendering a final determination within 20 days of the date on which the hearing record is closed. The participants will be notified in writing of the final disposition which will contain an explanation of the reasons for the final decision.

The final determination may be appealed to the Board of Directors of the FDIC. To do so a request for review must be filed the Executive Secretary of the FDIC within 15 days of the date on which notification of the final decision is received.

The proposal indicates that the procedures currently set out in Sec. Sec. 303.10(f) through 303.10(i), 303.10(k) and 303.10(m) will govern the conduct of the hearing. Section 303.10 is titled "Hearings and other meetings". Paragraph (f) governs participation in hearings.

Paragraph (g) governs transcripts. Paragraph (h) governs presentations and information that may be submitted. It also identifies federal laws that are not applicable to hearings. Paragraph (i) governs the closing of the hearing record. Paragraph (k) governs the computation of time. Paragraph (m) provides that the Board of Directors may delegate by resolution to the presiding officer the authority to adopt different procedures in individual matters.

#### Request for Comments

In addition to any other comments on the proposal, the FDIC specifically requests comment on the following.

1. Is it advisable for the FDIC to adopt separate rules implementing section 18(j)(1) of the FDI Act and section 23A and 23B of the FRA as they apply to insured State nonmember banks?
2. If the FDIC does adopt separate regulations, should the regulation set out the full text of Regulation W rather than adopt the proposed cross reference? If the FDIC adopted a full text version it would be identical to Regulation W with the exception that "insured State nonmember bank" would be substituted for "member bank"; "FDIC" would be substituted for "Board"; "FDIC" would be substituted for "appropriate Federal banking agency"; the definition of "member bank" would be replaced with a definition of "State nonmember bank" (definition would be the same as currently proposed) and the authority, purpose and scope paragraph as found in Regulation W would be modified to read as those paragraphs are proposed for comment.
3. Should the FDIC continue its past practice of allowing the FRB to act on exemption requests by insured State nonmember banks or adopt the proposed change in practice which would direct insured State nonmember banks to file such requests with the FDIC, which would then grant or deny the request?
4. If the FDIC adopts the practice of acting on exemption requests, are the proposed procedures for exemption requests sufficiently clear? Is the information that is required to be presented in an exemption request burdensome? Should the regulation require that additional, specifically identified information be included in the request? Should the regulation provide specifics on the time in which the FDIC will act on exemption requests?
5. Are the proposed hearing procedures adequate? What additional procedures if any should be included? Should the regulation specify that the hearing will take place no later than a certain specified period of time after the request for hearing is submitted to the FDIC? Is it appropriate to apply the procedures found in Sec. 303.10(f) through 303.10(i), 303.10(k) and 303.10(m) to a controlling influence hearing?
6. Should the Board of Directors delegate the authority to grant exemptions under the regulation or retain the authority to grant exemptions at the Board level?
7. Should the Board of Directors delegate the authority to make a final control determination or should that authority be retained only at the Board level?
8. If decision making authority with respect to control determinations is delegated, is it appropriate to allow an appeal of the decision and if so, to whom?
9. Is the FDIC correct in its initial view that the proposed exemption for section 24 subsidiaries that were established prior to the publication of this proposal from part 324 will not adversely impact the public or be inconsistent with the purposes of section 23A and 23B?
10. Should the FDIC draft the subsidiary exemption more narrowly? If so, why? Should the exemption be broader in scope? If so, why?

11. Should the FDIC consider additional exemptions at this time?
12. Should the FDIC consider granting a phase-in period for transactions that were entered into prior to the publication of the proposal? If so, should the phase-in period mirror the phase-in period the FRB adopted for

[[Page 12577]]

member banks (i.e., three months from the effective date of the rule) or would some other period be more appropriate?

13. Should the FDIC consider exempting from part 324 transactions that were entered into prior to the publication of the proposal? If so, why? Would such an exemption pose safety and soundness issues?

14. FDIC's view is that insured State branches, agencies, and commercial lending companies of foreign banks are subject to the substantive provisions of Regulation W and this part. Comment is requested on whether the proposed regulation is sufficiently clear in that regard and whether or not the FDIC is justified in its view.

15. Are the proposed amendments to the FDIC's regulations written clearly and in "plain language"? If not, what changes should be made to the proposed language to make it clearer and easier to understand?

#### Paperwork Reduction Act

In accordance with the Paperwork Reduction Act (44 U.S.C. 3501 et seq.), the FDIC may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget (OMB) control number. The collection of information contained in this rule has been submitted to OMB for review.

Written comments on the collection of information should be sent to the Joseph F. Lackey, FDIC desk officer: Office of Management and Budget, Office of Information and Regulatory Affairs, New Executive Office Building, Washington, DC 20503. Copies of comments should also be sent to: Thomas Nixon, Legal Division, FDIC, 550 17th Street, NW., Washington, DC 20429, (202) 898-8766. For further information on the Paperwork Reduction Act aspect of this rule, contact Thomas Nixon at the above address.

Comment is solicited on:

1. Whether the collection of information is necessary for the proper performance of FDIC functions, including whether the information will have practical utility;
2. The accuracy of our estimate of burden of the proposed collection of information, including the validity of the methodology and assumptions used;
3. The quality, utility, and clarity of the information to be collected;
4. Ways to minimize the burden of the information collection on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, for example, permitting electronic submission of responses; and
5. Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information.

Title of the collection: Transactions with affiliates.

Summary of the collection: As discussed more fully in the preamble, the FDIC's 12 CFR part 324 will make clear that insured State nonmember institutions must conform to the standards of FRB's Regulation W and that the FDIC is responsible for administering Regulation W as it applies to such institutions, including receiving and acting on notices required by Regulation W.



The notices required in this collection are required to evidence compliance with sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c and 371c-1) and section 18(j)(1) of the Federal Deposit Insurance Act ("FDI Act"). The respondents for part 324 will be insured State nonmember institutions.

Regulation W established four notices at (12 CFR) sections 223.15(b)(4), 223.31(d)(4), 223.41(d)(2) and 223.43(b). The FDIC will require insured state nonmember institutions to provide the first three of these notices to the FDIC by the part 324's cross-reference to Regulation W. The fourth Regulation W notice (223.43(b)) will not be required through the part 324 cross-reference. Instead, the FDIC equivalent of that notice will be required through 12 CFR 303.251.

The first notice requirement, described in Regulation W's section 223.15(b)(4), is a condition to an exemption for renewals of loan participations involving problem loans. Regulation W requires the participating depository institution to provide its appropriate Federal banking agency with written notice of the renewal or extension of additional credit not later than 20 days after consummation. The FDIC is the appropriate Federal banking agency to which insured State nonmember institutions are to provide this notice. There will be no reporting form associated with this information collection. The FDIC estimates that approximately three insured State nonmember institutions will file this notice annually and that it will take approximately two hours to prepare the notice.

The second notice requirement, described in Regulation W's section 223.31(d)(4), is a condition to an exemption for a depository institution's acquisition of an affiliate that becomes an operating subsidiary of the institution after the acquisition. Regulation W requires the institution to provide its appropriate Federal banking agency and the FRB with written notice of its intention to acquire the company at or before the time that the company becomes an affiliate of the institution. Through part 324's cross-reference, insured State nonmember institutions will provide that notice to the FDIC. There will be no reporting form associated with this information collection. The FDIC estimates that approximately three insured State nonmember institutions will file this notice annually and that it will take approximately six hours to prepare the notice.

The third notice requirement, described in Regulation W's section 223.41(d)(2), is a condition to an exemption for internal corporate reorganization transactions. Regulation W requires the depository institution to provide its appropriate Federal banking agency and the FRB with written notice of the transaction before consummation. Insured State nonmember institutions will provide notice to the FDIC. The notice must describe the primary business activities of the affiliate and indicate the proposed date of the reorganization. There will be no reporting form associated with this information collection. The FDIC estimates that approximately seven insured state nonmember institutions will file this notice annually and that it will take approximately six hours to prepare a notice.

Finally, part 324 will not require insured state nonmember institutions to send a notice to the FDIC through a cross-reference to Regulation W's section 223.43(b). Instead, pursuant to Sec. 303.251, they must submit a request to the appropriate FDIC regional office. The request must describe in detail the transaction or relationship for which the institution seeks exemption; explain why the FDIC should exempt the transaction or relationship; and explain how the exemption would be in the public interest and consistent with the purposes of section 23A. There will be no reporting form associated with this information collection. The FDIC estimates that approximately two insured State nonmember institutions will file these requests annually and that it will take approximately 10 hours to prepare a request.

Burden estimate: The total estimated annual burden for insured State nonmember institutions that must comply with the above-mentioned requirements is 86 hours. Based on a rate of \$50 per hour, the total annual

[[Page 12578]]

cost to the public for these collections of information is estimated to be \$4,300.

#### Regulatory Flexibility Act

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)), the FDIC must publish an initial regulatory flexibility analysis with this rulemaking or certify that the proposed rule, if adopted, will not have a significant economic impact on a substantial number of small entities. For the purposes of the required analysis or certification, financial institutions with total assets of \$150 million or less are considered to be "small entities". For the reasons set out below the FDIC hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rule, if adopted, will not have a significant economic impact on a substantial number of small entities.

Sections 23A and 23B of the FRA limit transactions between a member bank and its affiliates. The FDIC enforces sections 23A and 23B of the FRA as to insured State nonmember banks under section 18(j)(1) of the FDI Act which provides that insured State nonmember banks are subject to sections 23A and 23B of the FRA as though they were member banks. Section 9 (Tenth) of the FDI Act authorizes the FDIC to issue such regulations as may be necessary to administer and carry out the purposes of those sections. The proposed rule would make clear to insured State nonmember banks that in order to comply with section 18(j)(1) of the FDI Act they must comply with the substantive provisions of FRB Regulation W which was adopted in final by the FRB on December 12, 2002 to implement the requirements and restrictions of sections 23A and 23B of the FRA as they apply to member banks. Regulation W is codified at 12 CFR 223. It appeared in volume 67 of the Federal Register at page 76560 (67 FR 76560). A full description of the reasons why the FRB considered and adopted Regulation W are set out in the Federal Register document which contained Regulation W as originally proposed for comment (66 FR 24186, May 11, 2001) and in Regulation W as adopted in final form. The FRB describes Regulation W as a regulation which, although designed to comprehensively implement sections 23A and 23B of the FRA, is a regulation that in large measure simply codifies the FRB's past practice and interpretations with respect to sections 23A and 23B. The reasons the FDIC is proposing to adopt a cross reference to Regulation W in its regulations and, is further proposing to amend its regulations to make clear that the FDIC is the appropriate agency to grant exemptions from sections 23A and 23B to insured State nonmember banks as well as to make other determinations under Regulation W, are set out more fully under the supplementary information section of this document. The proposed rule would apply to all insured State nonmember banks regardless of their size.

Regulation W largely codifies the application of section 23A and 23B of the FRA as to member and State nonmember banks as interpreted and applied before that rule's adoption. In most instances the differences between what a bank needed to do to comply with section 23A or 23B previously and what is required to be done in order to comply with section 23A or 23B post Regulation W are minimal. In many instances Regulation W actually grants relief from restrictions contained in the statute. Regulation W does contain some new notice

requirements and sets out specifics as to filing requirements if a bank wishes to obtain an exemption from section 23A as to a particular transaction or relationship. Those requirements are discussed above under the heading "Paperwork Reduction Act". Of the requirements discussed under that heading, the requirements necessary to obtain an exemption are the most onerous. Based on FDIC's experience as to the number and size of State nonmember banks that have sought such exemptions in the past, we anticipate very few such requests and the institutions most likely to file an exemption request can be expected to be larger than \$150 million in total assets. In 2003 only three insured State nonmember banks requested exemptions from section 23A. Only one of the three institutions was under \$150 million in total assets. Regulation W also requires a notice in connection with corporate reorganizations that are exempted from some of the restrictions of section 23A and 23B without need of a case-by-case determination. Again based on our past experience we anticipate that banks that will take advantage of this exemption are likely to be larger than \$150 million in total assets. Over the years, exemption requests have typically involved reorganization transactions and as stated above, banks that file exemption requests are more likely to be banks in excess of \$150 million in total assets. Although we cannot come to the same conclusion with respect to the final two categories of notices described under the Paperwork Reduction Act heading, those notice requirements are minimal in terms of the information required to be filed. Banks will not require the services of attorneys, consultants, appraisers, accountants or other professionals to prepare and submit the notices nor do these notices require the use of sophisticated computer programs, statistical analysis, or other complex tracking or recordkeeping systems. While some aspects of Regulation W may require tracking or other compliance systems in order for a bank to comply with the requirements of the rule or to take advantage of certain exemptions contained in the rule, those systems as well as any burden arising out of FDIC's proposed rule would be present for State nonmember banks regardless of whether the FDIC adopts the proposal or not. The impact of the proposed rule is largely procedural in that its purpose is to clarify for State nonmember banks that it is the FDIC that administers the requirements of Regulation W as to insured state nonmember banks. The rule does not impose any new or different substantive requirement. In short, proposed part 324 does not itself impose any burden on small institutions that is not already imposed under Regulation W.

#### Impact on Families

The FDIC has determined that this proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Public Law 105-277, 112 Stat. 2681 (1998).

#### List of Subjects

##### 12 CFR Part 324

Banks, banking, Safety and Soundness, Transactions with affiliates.

##### 12 CFR Part 303

Administrative practice and procedure, Authority delegations (Government agencies), Bank deposit insurance, Banks, banking, Bank merger, Branching, Foreign branches, Foreign investments, Gold parachute payments, Insured branches, Interstate branching, Reporting

and recordkeeping requirements, Savings associations.

The Board of Directors of the Federal Deposit Insurance Corporation hereby proposes to add a new part 324 to title 12 of the Code of Federal Regulations and amend part 303 of title 12 of the Code of Federal Regulations as follows:

1. The authority citation for part 324 reads as follows:

Authority: 12 U.S.C. 1819(tenth), 1828(j)(1).

2. New part 324 is added to read as follows:

[[Page 12579]]

## PART 324--TRANSACTIONS WITH AFFILIATES

Sec.

324.1 Authority, purpose and scope.

324.2 Affiliate transactions.

324.3 Filings, submissions, requests and hearings.

324.4 Definitions and usage of terms.

324.5 Exemptions.

324.6 Controlling influence determinations.

Sec. 324.1 Authority, purpose and scope.

(a) Authority. This part is issued under the authority of sections 9 (tenth) and 18(j)(1) of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1819 (tenth), 1828(j)(1)).

(b) Purpose. This part implements section 18(j)(1) of the FDI Act and sections 23A and 23B of the Federal Reserve Act (FRA) (12 U.S.C. 371c, 371c-1) as to insured State nonmember banks. Section 18(j)(1) of the FDI Act makes insured State nonmember banks subject to the restrictions of sections 23A and 23B of the FRA in the same manner and to the same extent as if insured State nonmember banks are member banks of the Federal Reserve System. Section 23A and 23B of the FRA establish certain quantitative limits and other prudential requirements for loans, purchases of assets, and certain other transactions between a member bank and its affiliates. Federal Reserve Board (FRB) Regulation W (12 CFR 223) implements sections 23A and 23B of the FRA as to member banks by defining terms used in sections 23A and 23B, explaining the requirements of those statutory provisions and exempting certain transactions from the restrictions and limitations of the FRA.

(c) Scope. This part applies to insured State nonmember banks.

Sec. 324.2 Affiliate transactions.

(a) General. Insured State nonmember banks are subject to the restrictions and limitations contained in section 23A and 23B of the FRA and FRB Regulation W on transactions by member banks with affiliates in the same manner and to the same extent as if they were member banks of the Federal Reserve System.

(b) Exception. Any subsidiary relationship that predates March 17, 2004, is exempt from the requirements and restrictions of this part that would otherwise apply if such relationship would not have been subject to section 23A and 23B of the FRA prior to December 12, 2002, because the subsidiary would not have at that time been considered to be an affiliate.

Sec. 324.3 Filings, submissions, requests and hearings.

Filings, submissions, and requests made under section 324.5 and section 324.6 of this part are governed by 12 CFR 303.251. All other filings, submissions or requests under this part are governed by subpart A of 12 CFR 303. Procedures to which member banks are subject under FRB Regulation W for filings, submissions, requests and hearings do not apply in the case of a State nonmember bank.

Sec. 324.4 Definitions and usage of terms.

For purposes of compliance with this part insured state nonmember banks should substitute "insured State nonmember bank" for "member bank" and "FDIC" for "Board" wherever those terms appear in Federal Reserve Board Regulation W. The phrase "appropriate Federal banking agency" as used in Federal Reserve Board Regulation W should in all instances be read to mean "FDIC". "State nonmember bank" has the same meaning as in 12 U.S.C. 1813(e)(2).

Sec. 324.5 Exemptions.

An insured State nonmember bank may request that the FDIC exempt transactions or relationships from the requirements of section 23A of the FRA as implemented by this part. Exemption requests may be granted by the FDIC in its discretion if it finds such exemption to be in the public interest and to be consistent with the purposes of section 23A.

Sec. 324.6 Controlling influence determinations.

Determinations by the FDIC that a shareholder or company directly or indirectly exercises a controlling influence over the management or policies of another company will only be made after notice and opportunity for hearing. Hearings will be conducted in accordance with 12 CFR 303.251.

3. The authority citation for part 303 continues to read as follows:

Authority: 12 U.S.C. 378, 1813, 1815, 1817, 1818, 1819 (Seventh and Tenth), 1820, 1823, 1828, 1831a, 1831e, 1831o, 1831p-1, 1831w, 1835a, 1843(l), 3104, 3105, 3108, 3207; 15 U.S.C. 1601-1607.

4. Sections 303.251 and 303.252 of subpart M of part 303 are redesignated as Sec. Sec. 303.252 and 303.253.

5. Section 303.251 is added to subpart M of part 303 to read as follows:

Subpart M--Other Filings

\*\*\*\*\*

Sec. 303.251 Affiliate transactions.

(a) Exemption requests. (1) Scope--This paragraph contains the procedures to be followed by an insured state nonmember bank that wants to obtain an order from the FDIC exempting affiliate transactions or relationships from the requirements of part 324 (12 CFR 324) and

section 23A of the Federal Reserve Act (12 U.S.C. 371c) as made applicable to insured state nonmember banks by section 18(j)(1) of the FDI Act (12 U.S.C. 1828(j)(1)).

(2) Where to File. Applicants shall submit a letter application to the appropriate FDIC office.

(3) Content of Filing. The application shall contain the following:

(i) A detailed description of the relationship or transaction for which the applicant is seeking an exemption,

(ii) An identification of the requirements or restrictions from which the applicant is seeking relief, and

(iii) A statement of why the requested relief is in the public interest and consistent with the purposes of section 18(j)(1) of the FDI Act.

(4) Additional information. The FDIC may request additional information at any time during the processing of the filing.

(5) Processing. The FDIC will provide the applicant with written notification of the final action when the decision is rendered.

(b) Controlling influence determinations. (1) Scope--This paragraph contains the procedures the FDIC will follow when determining for the purposes of part 324 whether a company or shareholder controls another company as a result of directly or indirectly exercising a controlling influence over the management or policies of such company.

(2) Opportunity for hearing. Prior to determining that a shareholder or a company has a controlling influence over the management or policies of another company, the shareholder or company will be provided written notice of an opportunity for hearing.

(3) Hearing requests. Requests for a hearing must be received by the FDIC no later than 10 days after a written notice of opportunity for a hearing is received.

(4) Where to File. Requests for a hearing must be submitted by letter to the appropriate FDIC office.

(5) Timing of hearing. Upon receipt of a request for hearing, the FDIC will acknowledge the request in writing and set such date for the hearing as is determined by the FDIC to be reasonable.

(6) Hearing Procedures. The presiding officer shall be the Director of the Division of Supervision and Consumer

[[Page 12580]]

Protection or the Director's designee. Hearings will be conducted in accordance with sections 303.10(f)-section 303.10(i), section 303.10(k) and section 303.10(m). The presiding officer is responsible for conducting the hearing, determining all procedural questions not governed by paragraph (b) of this section and making the final determination within 20 days of the date on which the hearing record is closed. Participants will be notified in writing of the final disposition and provided an explanation of the reasons for the final decision.

(7) Review of final decision. Final decisions resulting in a determination that control exists may be appealed to the Board of Directors of the FDIC by filing a request for review with the Executive Secretary of the FDIC no later than 15 days after the date on which written notification of the final decision is received.

Dated at Washington, DC, this 10th day of March, 2004.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.  
Robert E. Feldman,  
Executive Secretary.

# Rules and Regulations

Federal Register

Vol. 69, No. 13

Wednesday, January 21, 2004

This section of the FEDERAL REGISTER contains regulatory documents having general applicability and legal effect, most of which are keyed to and codified in the Code of Federal Regulations, which is published under 50 titles pursuant to 44 U.S.C. 1510.

The Code of Federal Regulations is sold by the Superintendent of Documents. Prices of new books are listed in the first FEDERAL REGISTER issue of each week.

## FEDERAL DEPOSIT INSURANCE CORPORATION

### 12 CFR Part 330

RIN 3064-AC54

### Deposit Insurance Regulations; Living Trust Accounts

**AGENCY:** Federal Deposit Insurance Corporation (FDIC).

**ACTION:** Final rule.

**SUMMARY:** The FDIC is amending its regulations to clarify and simplify the deposit insurance coverage rules for living trust accounts. The rules are amended to provide coverage up to \$100,000 per qualifying beneficiary who, as of the date of an insured depository institution failure, would become the owner of the living trust assets upon the account owner's death.

**EFFECTIVE DATE:** April 1, 2004.

**FOR FURTHER INFORMATION CONTACT:** Joseph A. DiNuzzo, Counsel, Legal Division (202) 898-7349; Kathleen G. Nagle, Supervisory Consumer Affairs Specialist, Division of Supervision and Consumer Protection (202) 898-6541; or Martin W. Becker, Senior Receivership Management Specialist, Division of Resolutions and Receiverships (202) 898-6644, Federal Deposit Insurance Corporation, Washington, DC 20429.

### SUPPLEMENTARY INFORMATION:

#### I. Background

In June 2003 the FDIC published a proposed rule to simplify the insurance coverage rules for living trust accounts ("proposed rule"). 68 FR 38645, June 30, 2003. The FDIC undertook this rulemaking because of the confusion among bankers and the public about the insurance coverage of these accounts.

A living trust is a formal revocable trust over which the owner (also known as the grantor) retains ownership during his or her lifetime. Upon the owner's

death, the trust generally becomes irrevocable. A living trust is an increasingly popular instrument designed to achieve specific estate-planning goals. A living trust account is subject to the FDIC's insurance rules on revocable trust accounts. Section 330.10 of the FDIC's regulations (12 CFR 330.10) provides that revocable trust accounts are insured up to \$100,000 per "qualifying" beneficiary designated by the account owner. If there are multiple owners of a living trust account, coverage is available separately for each owner. Qualifying beneficiaries are defined as the owner's spouse, children, grandchildren, parents and siblings. 12 CFR 330.10 (a).

The most common type of revocable trust account is the "payable-on-death" ("POD") account, comprised simply of a signature card on which the owner designates the beneficiaries to whom the funds in the account will pass upon the owner's death. The per-beneficiary coverage available on revocable trust accounts is separate from the insurance coverage afforded to any single-ownership accounts held by the owner or beneficiary at the same insured institution. That means, for example, if an individual has at the same insured bank or thrift a single-ownership account with a balance of \$100,000 and a POD account (naming at least one qualifying beneficiary) with a balance of \$100,000, both accounts would be insured separately for a combined amount of \$200,000. If the POD account names more than one qualifying beneficiary, then that account would be insured for up to \$100,000 per qualifying beneficiary. 12 CFR 330.10(a).

Separate, per-beneficiary insurance coverage is available for revocable trust accounts only if the account satisfies certain requirements. First, the title of the account must include a term such as "in trust for" or "payable-on-death to" (or corresponding acronym). Second, each beneficiary must be either the owner's spouse, child, grandchild, parent or sibling. Third, the beneficiaries must be specifically named in the deposit account records of the depository institution. And fourth, the account must evidence an intent that the funds shall belong unconditionally to the designated beneficiaries upon the owner's death. 12 CFR 330.10(a) and (b).

As noted, the most common form of revocable trust account is the POD account, consisting simply of a signature card. With POD accounts, the fourth requirement for per-beneficiary coverage does not present a problem because the signature card normally will not include any conditions upon the interests of the designated beneficiaries. In other words, the signature card provides that the funds shall belong to the beneficiaries upon the owner's death. In contrast, many living trust agreements provide, in effect, that the funds might belong to the beneficiaries depending on various conditions. The FDIC refers to such conditions as "defeating contingencies" if they create the possibility that the beneficiaries may never receive the funds following the owner's death.

Living trust accounts started to emerge in the late 1980s and early 1990s. At that time, the FDIC responded to a significant number of questions about the insurance coverage of such accounts, often times reviewing the actual trust agreements to determine whether the requirements for per-beneficiary insurance were satisfied. In the FDIC's review of numerous such trusts, it determined that many of the trusts included conditions that needed to be satisfied before the named beneficiaries would become the owners of the trust assets. For example, some trusts required that the trust assets first be used to satisfy legacies in the grantor's will; the remaining assets, if any, would then be distributed to the trust beneficiaries. Other trusts provided that, in order to receive any benefit under the trust, the beneficiary must graduate from college. Because of the prevalence of defeating contingencies among living trust agreements and the increasing number of requests to render opinions on the insurance coverage of specific living trust accounts, in 1994 the FDIC issued "Guidelines for Insurance Coverage of Revocable Trust Accounts (Including 'Living Trust' Accounts)." FDIC Advisory Opinion 94-32 (May 18, 1994). As part of its overall simplification of the deposit insurance regulations, in 1998 the FDIC revised § 330.10 to include a provision explaining the insurance coverage rules for living trust accounts. 12 CFR 330.10(f). That provision included a definition of defeating contingencies.

Despite the FDIC's issuance of guidelines on the insurance coverage of living trust accounts and its inclusion of a special provision in the insurance regulations explaining the coverage of these accounts, there still is significant public and industry confusion about how the insurance rules apply to living trust accounts. Time has shown that the basic rules on the coverage of POD accounts are not fully adaptable to living trust accounts. The POD rules were written to apply to signature-card accounts, not lengthy, detailed trust documents. Because living trust accounts and PODs are subject to the same insurance rules and analysis, depositors and bankers often mistakenly believe that living trust accounts are automatically insured up to \$100,000 per qualifying beneficiary without regard to any terms in the trust that might prevent the beneficiary from ever receiving the funds. Our experience indicates that in a significant number of cases that is not so under existing rules. Because of the existence of defeating contingencies in the trust agreement, a living trust account often fails to satisfy the requirements for per-beneficiary coverage. Thus, the funds in the account are treated as the owner's single-ownership funds and, after being added to any other single-ownership funds the owner has at the same institution, insured to a limit of \$100,000. The funds in a non-qualifying living trust account with more than one owner are deemed the single-ownership funds of each owner, with the corresponding attribution of the funds to each owner's single-ownership accounts.

The FDIC recognizes that the rules governing the insurance of living trust accounts are complex and confusing. Under the current rules, the amount of insurance coverage for a living trust account can only be determined after the trust document has been reviewed to determine whether there are any defeating contingencies. Consequently, in response to questions about coverage of living trust accounts, the FDIC can only advise depositors and bankers that they should assume that such accounts will be insured for no more than \$100,000 per grantor, assuming the grantor has no single-ownership funds in the same depository institution. Otherwise, the FDIC suggests that the owners of living trust accounts seek advice from the attorney who prepared the trust document. Depositors who contact the FDIC about their living trust insurance coverage are often troubled to learn that they cannot definitively determine the amount of their coverage without a legal analysis of their trust

document. Also, when a depository institution fails the FDIC must review each living trust to determine whether the beneficiaries' interests are subject to defeating contingencies. This often is a time-consuming process, sometimes resulting in a significant delay in making deposit insurance payments to living trust account owners.

## II. The Proposed Rule

In the proposed rule issued in June 2003, the FDIC identified and requested comments on what it believed to be two viable alternatives to address the confusion surrounding the insurance coverage of living trust accounts.

The first alternative provided for coverage up to \$100,000 per qualifying beneficiary named in the living trust irrespective of defeating contingencies ("Alternative One").

The FDIC would identify the beneficiaries and their ascertainable interests in the trust from the depository institution's account records and provide coverage on the account up to \$100,000 per qualifying beneficiary. As with POD accounts, under Alternative One insurance coverage would be provided up to \$100,000 per qualifying beneficiary limited to each beneficiary's ascertainable interest in the trust.

Alternative One expressly required that the deposit account records of the institution indicate the ownership interest of each beneficiary in the living trust. The information could be in the form of the dollar amount of each beneficiary's interest or on a percentage basis relative to the total amount of the trust assets. The FDIC requested specific comments on how such a recordkeeping requirement should be satisfied when a trust provided for different levels of beneficiaries whose interests in the trust depend on certain conditions, including the death of a "higher-tiered" beneficiary. In the proposed rule the FDIC noted that Alternative One generally would result in an increase in deposit insurance coverage because, unlike under the current rules, beneficiaries would not be required to have an unconditional interest in the trust in order for the account to qualify for per-beneficiary coverage.

The second alternative in the proposed rule provided, in essence, for a separate category of ownership for living trust accounts, insuring such accounts up to \$100,000 per account owner ("Alternative Two"). An individual grantor would be insured up to a total of \$100,000 for all living trust accounts he or she had at the same depository institution, regardless of the number of beneficiaries named in the trust, the grantor's relationship to the

beneficiaries and whether there were any defeating contingencies in the trust. The coverage for a living trust account would be separate from the coverage afforded to any single-ownership accounts or qualifying joint accounts the owner might have at the same depository institution. Where there were joint owners of a living trust account, the account would be insured up to \$100,000 per grantor. Such accounts also would be separately insured from any joint accounts either grantor might have at the same insured depository institution. In the proposed rule the FDIC noted that Alternative Two likely would result in reduced coverage for owners of living trusts naming more than one qualifying beneficiary because per-beneficiary coverage would be eliminated.

## III. Comments on the Proposed Rule

The FDIC received forty-three comments on the proposed rule. Thirty-seven comments were from banks and savings associations and six were from state and national depository institution trade associations. Twenty-five comments were in favor of Alternative One or a modified version of that alternative and sixteen were in favor of Alternative Two. Two comments discussed the characteristics of both alternatives without expressing a preference for either one. Many of the comments on the proposed rule praised the FDIC for attempting to simplify and clarify the living trust rules. All the comment letters are available on the FDIC Web site, <http://www.fdic.gov/regulations/laws/federal/propose.html>.

Seventeen comments expressed support for Alternative One as proposed. In general, those commenters said Alternative One would provide more coverage for depositors than Alternative Two and would be more in line with the current coverage available for POD accounts. As such, depositors would not have to place their money with more than one institution or through deposit brokers to obtain full insurance coverage on their deposits. Along these lines, two commenters mentioned that Alternative One would assist depositors in estate-planning efforts by allowing them to place a sizable portion of their assets at one insured institution. Several comments lauded the certainty provided by Alternative One. One stated that "[Alternative One] provides the amount of coverage and the clarity and understanding of living trust accounts that our customers deserve." Another argued that it would be inequitable to treat POD accounts and living trust accounts differently because they both



are in the owner's control during his or her lifetime and may be modified at any time prior to the owner's death.

Eight of the twenty-five commenters who supported Alternative One, however, expressed concerns about certain aspects of the alternative and asked the FDIC to modify Alternative One before finalizing it. One state financial institution trade association voiced strong opposition to "any requirement for financial institutions to: Obtain any part of a trust document; provide a certification of trust existence; and specifically identify a qualifying beneficiary's interest in trust assets or relationship to the grantor(s)."

A national depository institutions trade group cautioned that the proposed recordkeeping requirements might jeopardize the protections afforded under certain state laws for financial institutions in dealing with trusts. It cited "compelling practical reasons" against the proposed recordkeeping requirements in Alternative One, noting that:

- Unlike POD accounts, for which the only document is the institution's account—opening record, living trusts can be lengthy, complicated documents that identify multiple tiers of beneficiaries.

- It is often difficult for bankers to get information from accountholders who may be confused by the complexity and terminology of their living trust documents.

- Living trusts can be amended or revoked at any time and depository institutions should not be expected to repeatedly contact their customers to determine whether their account information is current.

- Customers might perceive such recordkeeping requirements as an invasion of privacy.

Two other trade associations and several depository institutions echoed these views.

Many of the commenters in favor of Alternative One without the proposed recordkeeping requirements suggested that the FDIC continue its current practice of ascertaining the existence of living trust beneficiaries and kinship information at the time an institution is closed. In addition to making the same points on the recordkeeping requirements as those noted above, another national trade association representing community banks said "we do not see how the FDIC can avoid the time-consuming process of reviewing trust agreements when a bank failure occurs."

Sixteen comments were in favor of Alternative Two. Generally, the consensus among these comments was,

as expressed by one community banker, "[Alternative Two is] easier [than Alternative One] to explain to the depositor and for the bank to keep track of." Another community banker described the option as "straightforward." A common point made by several commenters was that, because of the simplicity of Alternative Two, depositors would be able to make an informed decision in placing living trust funds with depository institutions. Another community banker noted that Alternative Two would be the "simplest, easiest and cleanest method" of insuring living trust deposits and added that "[w]e are not lawyers nor tax accountants and we should not have to 'dive' into someone's trust papers and try to decide how many beneficiaries, the relationships (of the parties) and if there are contingencies in the trust."

Three commenters who favored Alternative Two suggested that under Alternative Two the insurance coverage for living trust accounts be increased to \$200,000 to address the reduction in coverage some depositors might experience as a result of the rule change. *(This is not a viable option for the FDIC because it would take an act of Congress to increase the basic deposit insurance amount.)*

A large regional bank commented that Alternative Two "appears to be the fairest treatment of these accounts as it treats them more like individual accounts. Since revocable accounts are generally used for the primary benefit of one, or sometimes two individuals, this seems more in line with policy of FDIC insurance than Alternative One."

Many comments in support of Alternative Two acknowledged that Alternative One also offered advantages to depositors and would be an improvement over the current rule, but noted that Alternative One would place an added burden on financial institutions by imposing new recordkeeping requirements and would place institutions in the position of requesting information from depositors that they likely would be unwilling or unable to provide for privacy and other reasons. One medium-sized institution favored Alternative Two because "we wouldn't have to track the names of the trust beneficiaries and their various interests." A community banker voiced support for Alternative Two, saying it would be "easier to understand by the customer and bank personnel." She noted that customers would have the option to open POD accounts to obtain separate per-beneficiary POD coverage.

#### IV. The Final Rule

##### A. General Explanation

Upon considering the comments on the proposed rule, the FDIC has revised the current living trust account rules to provide for insurance coverage of up to \$100,000 per qualifying beneficiary who, as of the date of an institution failure, would become entitled to the living trust assets upon the owner's death. This is a modified version of Alternative One in the proposed rule, based in part on a comment from a community banker that living trust coverage be based on beneficiaries "without death related contingencies." Under the final rule, coverage will be determined on the interests of qualifying beneficiaries irrespective of defeating contingencies. A beneficiary whose trust interest is dependent on the death of another trust beneficiary, however, will not qualify.

For example, an account for a living trust providing that the trust assets go in equal shares to the owner's three children upon the owner's death would be eligible for \$300,000 of deposit insurance coverage. If the trust provides that the funds would go to the children only if they each graduate from college prior to the owner's death, the coverage would still be \$300,000, because defeating contingencies will no longer be relevant for deposit insurance purposes. Another example is where a trust provides that the owner's spouse becomes the owner of the trust assets upon the owner's death but, if the spouse predeceases the owner, the three children then become the owners of the assets. If the spouse is alive when the institution fails, the account will be insured up to a maximum of \$100,000, because only the spouse is entitled to the assets upon the owner's death. If at the time of the institution failure, however, the spouse has predeceased the owner, then the account would be eligible for up to \$300,000 coverage because there would be three qualifying beneficiaries entitled to the trust assets upon the owner's death.

In developing the final rule the FDIC was guided by two interwoven objectives: To simplify the existing rules and to provide coverage similar to POD account coverage. The FDIC believes the final rule achieves these objectives because it is reasonably straight-forward and because, as with POD accounts, coverage is based on the actual interests of qualifying beneficiaries. The final rule is similar to Alternative One but provides coverage based on qualifying beneficiaries who have an immediate interest in the trust assets upon the grantor's death. This concept is the

same as the coverage theory applicable to POD accounts: To provide coverage based on the interests of the beneficiaries who will receive the account funds when the owner dies, determined as of the date of the institution failure. Alternative One could have allowed for potentially open-ended coverage in some situations, particularly where a trust provided for tiered, or sequential, beneficiaries whose interests in the trust depend on whether "higher-tiered" beneficiaries predecease them.

Moreover, Alternative One would have required that a depository institution's deposit account records indicate the name and ascertainable interest of each qualifying beneficiary in the trust. The FDIC was persuaded by a majority of comments contending that requiring institutions to maintain records on the names of living trust beneficiaries and their interests in the respective trusts would be unnecessary and burdensome. The FDIC agrees with the industry assessment of that proposed requirement because the grantor of a living trust might during his or her lifetime change the trust beneficiaries and modify the terms of the trust. Requiring the grantor to inform a depository institution of these changes and requiring depository institutions to maintain records on such information is impractical and unnecessarily burdensome. Hence, a key feature of the final rule is that it requires no recordkeeping requirement other than an indication on a depository institution's records that the account is a living trust account. Upon an institution failure, FDIC claims agents would identify the beneficiaries and determine their interests by reviewing the trust agreement obtained from the depositor. At that time depositors would attest to their relationship to the named beneficiaries.

In the final rule the FDIC has eliminated an unnecessary recordkeeping requirement. Specifically, the names of living trust beneficiaries will no longer have to be recorded in the deposit account records of an insured institution in order for the account to qualify for the deposit insurance provided for living trust accounts. The removal of this recordkeeping requirement supports the ongoing efforts of the FDIC and the other federal banking regulators, under the Economic Growth and Regulatory Paperwork Reduction Act ("EGRPRA"), to eliminate unnecessary regulatory requirements. Detailed information about the EGRPRA project is available at <http://www.egrpra.gov>.

The FDIC believes deposit insurance coverage under the final rule would match the coverage many depositors now expect for their living trust accounts. Generally, depositors believe that living trust coverage is essentially the same as POD account coverage. In other words, insurance is based on the number of qualifying beneficiaries with an ownership interest in the account, regardless of any conditions, or contingencies, affecting those interests. The final rule will match those expectations because it provides coverage more closely aligned with POD coverage than the former rules. The FDIC believes the final rule will provide bankers and depositors with a better understanding of the living trust account deposit insurance rules and will help to eliminate the present confusion surrounding the coverage of living trust accounts.

#### *B. Treatment of Non-Qualifying Beneficiaries*

The treatment of non-qualifying beneficiaries under the final rule will be the same as under the current POD rules. Interests of non-qualifying beneficiaries in a living trust will be insured as the owner's single-ownership (or individual) funds. As such, those interests will be added to any other single-ownership funds the owner holds at the same institution and insured to a total of \$100,000 in that account-ownership capacity. For example, assume a living trust provides that the grantor's assets shall belong equally to her husband and nephew upon her death. A living trust account with a balance of \$200,000 held for that trust would be insured for at least \$100,000 because there is one qualifying beneficiary (the grantor's spouse) who, upon the institution failure, would be entitled to the funds upon the grantor's death. Because the nephew is a non-qualifying beneficiary, the \$100,000 attributable to him would be insured as the grantor's single-ownership funds. If the grantor has no other single-ownership funds at the institution, the full \$200,000 of the living trust account would be insured—\$100,000 under the grantor's revocable trust ownership capacity and \$100,000 under the grantor's single-ownership capacity. If, however, the grantor also has a single-ownership account with a balance of, say, \$20,000, the \$100,000 of the living trust account attributable to the nephew would be added to that amount and the combined amount, in the grantor's single-ownership capacity, would be insured to a limit of \$100,000, leaving \$20,000 uninsured. This result and calculation methodology is the same as

under the current rules for POD accounts.

#### *C. Treatment of Life-Estate and Remainder Interests*

Living trusts sometime provide for a life estate interest for designated beneficiaries and a remainder interest for other beneficiaries. The final rule addresses this situation by deeming each life-estate holder and each remainder-man to have an equal interest in the trust assets. Insurance is then provided up to \$100,000 per qualifying beneficiary. For example, assume a grantor creates a living trust providing for his wife to have a life-estate interest in the trust assets with the remaining assets going to their two children upon the wife's death. The assets in the trust are \$300,000 and a living trust account is opened for that full amount. Unless otherwise indicated in the trust, the FDIC would deem each of the beneficiaries (all of whom here are qualifying beneficiaries) to own an equal share of the \$300,000; hence, the full amount would be insured. This result would be the same even if the wife has the power to invade the principal of the trust, inasmuch as under the final rule defeating contingencies are no longer relevant for insurance purposes.

Another example would be where the living trust provides for a life estate interest for the grantor's spouse and remainder interests for two nephews. In that situation the method for determining coverage would be the same as that indicated above: Unless otherwise indicated, each beneficiary would be deemed to have an equal ownership interest in the trust assets and coverage would be provided accordingly. Here the life-estate holder is a qualifying beneficiary (the grantor's spouse) but the remainder-men (the grantor's nephews) are not. As such (assuming an account balance of \$300,000), the living trust account would be insured for at least \$100,000 because there is one qualifying beneficiary (the grantor's spouse). The \$200,000 attributable to the grantor's nephews would be insured as the grantor's single-ownership funds. If the grantor has no other single-ownership funds at the same institution, then \$100,000 would be insured as the grantor's single-ownership funds. Thus, the \$300,000 in the living trust account would be insured for a total of \$200,000 and \$100,000 would be uninsured. The FDIC believes this is a simple, balanced approach to insuring living trust accounts where the living trust provides for one or more life estate interests.

## V. Effective Date

The final rule will become effective on April 1, 2004, the beginning of the first calendar quarter following the publication date of the final rule. The final rule will apply as of that date to all living trust accounts unless, upon a depository institution failure, a depositor who established a living trust account before April 1, 2004, chooses coverage under the previous living trust account rules. For any depository institution failures occurring between January 13, 2004, and April 1, 2004, the FDIC will apply the final rule if doing so would benefit living trust account holders of such failed institutions.

## VI. Paperwork Reduction Act

The final rule will simplify the FDIC's regulations governing the insurance of living trust accounts. It will not involve any new collections of information pursuant to the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*). Consequently, no information has been submitted to the Office of Management and Budget for review.

## VII. Regulatory Flexibility Act

The FDIC certifies that the final rule will not have a significant economic impact on a substantial number of small businesses within the meaning of the Regulatory Flexibility Act (5 U.S.C. 605(b)). The amendments to the deposit insurance rules will apply to all FDIC-insured depository institutions, including those within the definition of "small businesses" under the Regulatory Flexibility Act. The final rule eliminates an existing requirement for all FDIC-insured institutions to designate living trust beneficiaries in deposit account records. This change in recordkeeping will result in a marginal reduction in time and effort for depository institution staff which will not significantly affect compliance costs. The rule imposes no new reporting, recordkeeping or other compliance requirements. Accordingly, the Act's requirements relating to an initial and final regulatory flexibility analysis are not applicable.

## VIII. The Treasury and General Government Appropriations Act, 1999—Assessment of Federal Regulations and Policies on Families

The FDIC has determined that the final rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999—Assessment of Federal Regulations and Policies on Families, enacted as part of the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 (Pub. L. 105-277, 112 Stat. 2681).

## IX. Small Business Regulatory Enforcement Fairness Act

The Office of Management and Budget has determined that the final rule is not a "major rule" within the meaning of the relevant sections of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA") (5 U.S.C. 801 *et seq.*). As required by SBFERA, the FDIC will file the appropriate reports with Congress and the General Accounting Office so that the final rule may be reviewed.

### List of Subjects in 12 CFR Part 330

Bank deposit insurance, Banks, banking, Reporting and recordkeeping requirements, Savings and loan associations, Trusts and trustees.

■ For the reasons stated above, the Board of Directors of the Federal Deposit Insurance Corporation hereby amends part 330 of chapter III of title 12 of the Code of Federal Regulations as follows:

### PART 330—DEPOSIT INSURANCE COVERAGE

■ 1. The authority citation for part 330 continues to read as follows:

**Authority:** 12 U.S.C. 1813(l), 1813(m), 1817(i), 1818(q), 1819 (Tenth), 1820(f), 1821(a), 1822(c).

■ 2. Section 330.10(f) is revised to read as follows:

#### § 330.10 Revocable trust accounts.

\* \* \* \* \*

(f) *Living trust accounts.* (1) This section also applies to revocable trust accounts held in connection with a formal revocable trust created by an owner/grantor and over which the owner/grantor retains ownership during his or her lifetime. These trusts are usually referred to as living trusts. If a named beneficiary in a living trust is a qualifying beneficiary under this section, then the account held in connection with the living trust is eligible for the per-qualifying-beneficiary coverage described in paragraph (a) of this section. This coverage will apply only if, at the time an insured depository institution fails, a qualifying beneficiary would be entitled to his or her interest in the trust assets upon the grantor's death and that ownership interest would not depend on the death of another trust beneficiary. If there is more than one grantor, then the beneficiary's entitlement to the trust assets must be upon the death of the last grantor. The coverage provided in this paragraph (f) shall be irrespective of any other conditions in the trust that might prevent a beneficiary from acquiring an

interest in the deposit account upon the account owner's death.

(*Example 1:* A is the owner of a living trust account with a deposit balance of \$300,000. The trust provides that, upon A's death, her husband shall receive \$100,000 and each of their two children shall receive \$100,000, but only if the children graduate from college by age twenty-four. Assuming A has no other revocable trust accounts at the same depository institution, the coverage on her living trust account would be \$300,000. The trust names three qualifying beneficiaries. Coverage would be provided up to \$100,000 per qualifying beneficiary regardless of any contingencies.)

(*Example 2:* B is the owner of a living trust account with a deposit balance of \$200,000. The trust provides that, upon B's death, his wife shall receive \$200,000 but, if the wife predeceases B, each of the two children shall receive \$100,000. Assuming B has no other revocable trust accounts at the same depository institution and his wife is alive at the time of the institution failure, the coverage on his living trust account would be \$100,000. The trust names only one beneficiary (B's spouse) who would become the owner of the trust assets upon B's death. If when the institution fails B's wife has predeceased him, then the account would be insured to \$200,000 because the two children would be entitled to the trust assets upon B's death.)

(2) The rules in paragraph (c) of this section on the interest of non-qualifying beneficiaries apply to living trust accounts. (*Example:* C is the owner of a living trust account with a deposit balance of \$200,000. The trust provides that upon C's death his son shall receive \$100,000 and his nephew shall receive \$100,000. The account would be insured for *at least* \$100,000 because one qualifying beneficiary (C's son) would become the owner of trust interests upon C's death. Because the nephew is a non-qualifying beneficiary entitled to receive an interest in the trust upon C's death, that interest would be considered C's single-ownership funds and insured with any other single-ownership funds C might have at the same institution. Assuming C has no other single-ownership funds at the institution, the full \$200,000 in the living trust account would be insured (\$100,000 in C's revocable trust account ownership capacity and \$100,000 in C's single-ownership account capacity).

(3) For living trusts accounts that provide for a life-estate interest for designated beneficiaries and a remainder interest for other beneficiaries, unless otherwise indicated in the trust, each life-estate holder and each remainder-man will be deemed to have equal interests in the trust assets for deposit insurance purposes. Coverage will then be provided under the rules in this

paragraph (f) up to \$100,000 per qualifying beneficiary.

(*Example 1:* D creates a living trust providing for his wife to have a life-estate interest in the trust assets with the remaining assets going to their two children upon the wife's death. The assets in the trust are \$300,000 and a living trust deposit account is opened for that full amount. Unless otherwise indicated in the trust, each beneficiary (all of whom here are qualifying beneficiaries) would be deemed to own an equal share of the \$300,000; hence, the full amount would be insured. This result would be the same even if the wife has the power to invade the principal of the trust, inasmuch as defeating contingencies are not relevant for insurance purposes.)

(*Example 2:* E creates a living trust providing for a life estate interest for her spouse and remainder interests for two nephews. The life estate holder is a qualifying beneficiary (E's spouse) but the remainder-men (E's nephews) are not. Assuming a deposit account balance of \$300,000, the living trust account would be insured for *at least* \$100,000 because there is one qualifying beneficiary (E's spouse). The \$200,000 attributable to E's nephews would be insured as E's single-ownership funds. If E has no other single-ownership funds at the same institution, then \$100,000 would be insured separately as E's single-ownership funds. Thus, the \$300,000 in the living trust account would be insured for a total of \$200,000 and \$100,000 would be uninsured.)

(4) In order for a depositor to qualify for the living trust account coverage provided under this paragraph (f), the title of the account must reflect that the funds in the account are held pursuant to a formal revocable trust. There is no requirement, however, that the deposit accounts records of the depository institution indicate the names of the beneficiaries of the living trust and their ownership interests in the trust.

(5) Effective April 1, 2004, this paragraph (f) shall apply to all living trust accounts, unless, upon a depository institution failure, a depositor who established a living trust account before April 1, 2004, chooses coverage under the previous living trust account rules. For any depository institution failures occurring between January 13, 2004 and April 1, 2004, the FDIC shall apply the living trust account rules in this revised paragraph (f) if doing so would benefit living trust account holders of such failed institutions.

\* \* \* \* \*

Dated at Washington, DC, this 13th day of January, 2004.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

[FR Doc. 04-1198 Filed 1-20-04; 8:45 am]

BILLING CODE 6714-01-P

## DEPARTMENT OF TRANSPORTATION

### Federal Aviation Administration

#### 14 CFR Part 95

[Docket No. 30402; Amdt. No. 446]

#### IFR Altitudes; Miscellaneous Amendments

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule.

**SUMMARY:** This amendment adopts miscellaneous amendments to the required IFR (instrument flight rules) altitudes and changeover points for certain Federal airways, jet routes, or direct routes for which a minimum or maximum en route authorized IFR altitude is prescribed. This regulatory action is needed because of changes occurring in the National Airspace System. These changes are designed to provide for the safe and efficient use of the navigable airspace under instrument conditions in the affected areas.

**EFFECTIVE DATE:** 0901 UTC, February 19, 2004.

**FOR FURTHER INFORMATION CONTACT:** Donald P. Pate, Flight Procedure Standards Branch (AMCAFS-420), Flight Technologies and Programs Division, Flight Standards Service, Federal Aviation Administration, Mike Monroney Aeronautical Center, 6500 South MacArthur Blvd., Oklahoma City, OK 73169 (Mail Address: P.O. Box 25082, Oklahoma City, OK 73125) telephone: (405) 954-4164.

**SUPPLEMENTARY INFORMATION:** This amendment to part 95 of the Federal Aviation Regulations (14 CFR part 95) amends, suspends, or revokes IFR altitudes governing the operation of all aircraft in flight over a specified route or any portion of that route, as well as the changeover points (COPs) for Federal airways, jet routes, or direct routes as prescribed in part 95.

#### The Rule

The specified IFR altitudes, when used in conjunction with the prescribed changeover points for those routes, ensure navigation aid coverage that is adequate for safe flight operations and free of frequency interference. The reasons and circumstances that create

the need for this amendment involve matters of flight safety and operational efficiency in the National Airspace System, are related to published aeronautical charts that are essential to the user, and provide for the safe and efficient use of the navigable airspace. In addition, those various reasons or circumstances require making this amendment effective before the next scheduled charting and publication date of the flight information to assure its timely availability to the user. The effective date of this amendment reflects those considerations. In view of the close and immediate relationship between these regulatory changes and safety in air commerce, I find that notice and public procedure before adopting this amendment are impracticable and contrary to the public interest and that good cause exists for making the amendment effective in less than 30 days.

#### Conclusion

The FAA has determined that this regulation only involves an established body of technical regulations for which frequent and routine amendments are necessary to keep them operationally current. It, therefore—(1) is not a “significant regulatory action” under Executive Order 12866; (2) is not a “significant rule” under DOT Regulatory Policies and Procedures (44 FR 11034; February 26, 1979); and (3) does not warrant preparation of a regulatory evaluation as the anticipated impact is so minimal. For the same reason, the FAA certifies that this amendment will not have a significant economic impact on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

#### List of Subjects in 14 CFR Part 95

Airspace, Navigation (air).

Issued in Washington, DC on January 13, 2004.

James J. Ballough,

Director, Flight Standards Service.

#### Adoption of the Amendment

■ Accordingly, pursuant to the authority delegated to me by the Administrator, part 95 of the Federal Aviation Regulations (14 CFR part 95) is amended as follows effective at 0901 UTC.

■ 1. The authority citation for part 95 continues to read as follows:

**Authority:** 49 U.S.C. 106(g), 40103, 40106, 40113, 40114, 40120, 44502, 44514, 44719, 44721.

■ 2. Part 95 is amended to read as follows:

# **RECENT DEVELOPMENTS UNDER THE UNIFORM COMMERCIAL CODE**

*John T. McGarvey  
Morgan & Pottinger, P.S.C.  
Louisville, Kentucky*

Copyright 2004. John T. McGarvey All Rights Reserved.

## **SECTION H**



## **RECENT DEVELOPMENTS UNDER THE UNIFORM COMMERCIAL CODE**

### **CASE LAW UPDATE ..... H-1**

The Cecilian Bank v. Sarver .....	H-1
Barnes v. Community Trust Bank .....	H-1
Jones v. Christian County School Employees Federal Credit Union .....	H-2
Wise v. Alpha Leasing Company, Inc. ....	H-3
Morgan v. Crawford .....	H-3
M.A. Walker Co., Inc. v. PBK Bank, Inc. ....	H-3
In Re: Alabama Land and Mineral Corp., National City Bank of Kentucky v. Toffel, Trustee .....	H-3
In Re: Kentuckiana Truck & Trailer Repair, Inc., Ralph and McKinley v. Stock Yards Bank and Trust Co. ....	H-4

### **STATUS OF KENTUCKY'S UNIFORM COMMERCIAL CODE ..... H-5**

Article 1 - General Provisions .....	H-5
Article 2 - Sales .....	H-5
Article 2A- Leases .....	H-5
Articles 3 and 4 - Negotiable Instruments, Bank Deposits and Collections .....	H-5
Article 5 - Letters of Credit .....	H-5
Article 6 - Bulk Sales .....	H-5
Article 7 - Documents of Title .....	H-6
Article 8 - Investment Securities .....	H-6

## **SECTION H**

Article 9 - Secured Transactions .....	H-6
<b>THE SECRETARY OF STATE’S UCC FILING SYSTEM .....</b>	<b>H-6</b>
<b>COMMON ERRORS IN FILING FINANCING STATEMENTS AND AMENDMENTS .....</b>	<b>H-6</b>
Common Errors for Rejection of Paper Financing Statements .....	H-6
Electronic Forms .....	H-8
Use of the Secretary of State’s Electronic Filing System .....	H-8
<b>APPENDIX .....</b>	<b>H-9</b>

## SECTION H



## 2004 CONFERENCE ON LEGAL ISSUES FOR FINANCIAL INSTITUTIONS

### RECENT DEVELOPMENTS UNDER THE UNIFORM COMMERCIAL CODE

John T. McGarvey  
Morgan & Pottinger, P.S.C.

***The Cecilian Bank v. Sarver*, 2003 WL 23005721, (Ky. App. Dec. 24, 2003 (No. 2002-CA-4076-MR)) (Not to be Published) (Motion for Discretionary Review Pending, 2004-SC-000036)**

The Kentucky Court of Appeals vacated a judgment of the Hardin Circuit Court which ruled the bank's suit on a note was outside the applicable statute of limitations. The 1990 revisions to Article 3 (effective in Kentucky January 1, 1997) provide, at KRS 355.3-118(1): "[A]n action to enforce the obligation of a party to a note payable at a definite time must be commenced within six (6) years after the due date or dates stated in the note or, if a due date is accelerated, within six (6) years after the accelerated due date."

The note matured January 15, 1994. The suit to enforce the note was not brought until August 31, 2000. The trial court found the action untimely and entered judgment for the defendant. Applying KRS 446.080(3), the Kentucky Court of Appeals found the new statute of limitations to be only prospective in nature and inappropriately applied by the trial court as retroactive.

Prior to the enactment of KRS 355.3-118, the applicable statute of limitations was the 15-year statute for written contracts, KRS 413.090. Now, 3-118 sets out a series of statutes of limitation for various forms of instruments, notes, and drafts.

***Barnes v. Community Trust Bank*, Ky. App, 121 S.W.3d 520 (Published Nov. 7, 2003)**

The bank obtained summary judgment in the Madison Circuit Court for a deficiency due under a retail installment contract. (Retail installment contracts for the purchase of a motor vehicle are governed by KRS 190.090 *et seq.*) The lawsuit to enforce the contract was filed five and one half years after the bank repossessed and sold its collateral. The issue raised by *Barnes* on appeal was whether the action was barred by the 4-year statute of limitations in KRS 355.2-725. Until *Barnes*, purchasers/assignees of retail motor vehicle paper in Kentucky had always assumed the applicable statute of limitations was the 15-year contract statute, KRS 413.090.

The Court of Appeals ruled in favor of *Barnes* and held that "an action for breach of a contract for sale . . . should have been brought within four years of defendant's breach." Although deciding the case under Article 2, Judge Huddleston, writing for a unanimous court,

reached out to the commercial reasonability test of Article 9 in writing the decision, despite Article 2's exclusion of security transactions. *See*, KRS 355.2-102.

In its Opinion, the Court neither discussed nor analyzed KRS 355.2-102, the scope section of Article 2, that holds transactions, which although in the form of an unconditional contract to sell, are intended to operate only as a security transaction, are excluded. Professor Hawkland harmonizes the intersection of Article 2 and Article 9 in this manner: "If a question arises as to the quality of the goods sold, the warranty sections of Article 2 will govern, but the rights of the seller to foreclose will be governed by Part [6] of Article 9. Hawkland, Uniform Commercial Code Series, § 2-102:5. Presumably the right to foreclose also included the right to collect the deficiency.

Neither does the Kentucky decision address a decision of the Supreme Court of North Carolina that found that state's legislature intended Article 9 to govern the security aspects of purchase money security agreements (including retail installment sale contracts), rejected the application of the 4-year statute of Article 2 § 725, and applied that state's 10-year statute of limitations for "sealed instruments."

Kentucky became the eighth state in the nation to apply the 4-year statute of Article 2 to the enforcement of motor vehicle retail installment contracts. (Maryland, one of the other states, applied the 4-year statute in lieu of a shorter statute for the enforcement of general contract obligations.)

When a purchaser finances a motor vehicle by means of a note and security agreement, with a bank or credit union, the applicable statute of limitation is the new 6-year statute under KRS 355.3-118. Senate Bill 72, in the 2004 Legislature, sought to harmonize the statutes of limitations for the two primary means of financing motor vehicles by adopting a similar 6-year statute to enforce contracts under KRS Chapter 190. The bill passed the senate and died in house committee.

The *Barnes* decision requires the holders of motor vehicle retail installment contracts to decide from what date the 4-year statute of limitations runs. Options are the date the customer first misses a payment, the date the holder accelerates the balance due under the contract, the date of sale in the event of repossession, or the maturity date. There is also the issue of whether payments subsequent to any of these events toll the statute of limitations. There are Kentucky cases, outside the area of retail installment contracts, that suggest subsequent payments on a debt toll a statute of limitation. However, without legislative relief, it is safe to say that if there has ever been a four year gap in payments, the statute has run.

***Jones v. Christian County School Employees Federal Credit Union*, (Ky. App. 2002-CA-001635 (Jan. 23, 2004)) (Not to be Published).**

*Jones* sought recovery from the credit union for conversion of a draft through forgery of *Jones'* endorsement as a co-payee. This is another action involving the statute of limitations

under KRS 355.3-118, where the Court correctly applied subsection 7(a) to bar an action for conversion of an instrument more than three years after the claim for relief accrues.

***Wise v. Alpha Leasing Company, Inc.*, (Ky. App. 2002-CA-001254 (Aug. 8, 2003)) (Not to be Published).**

The leasing company was protected from an action based on breach of implied warrant and merchantability through application of KRS 355.2A-212 and 355.2A-213 which contain exceptions for a "finance lease." The lessor is protected from these claims when the lessor does not select, manufacture, or supply the leased goods.

***Morgan v. Crawford*, (Ky. App. 2002-CA-000339 (May 16, 2003)) (Not to be Published)**

Another case that should have been published. It correctly applies Revised Article 3, including a revision to KRS 355.1-207(2), to overrule the prior Court of Appeals decision in *Ditch Witch Trenching Co., of Ky., Inc. v. C & S Carpentry Services, Inc.*, Ky. App. 812 S.W. 2d, 171 (1991) on payment in full checks.

KRS 355.3-311 (effective January 1, 1997) specifically provides that if a person against whom a claim is asserted proves that they in good faith tender payment as full satisfaction, and the amount was unliquidated or subject to a bone fide dispute, and the claimant obtained payment of the instrument, the claim is discharged if the person against whom the claim is asserted proves that the instrument, or an accompanying writing contained a conspicuous statement to the effect that the instrument was tendered as full satisfaction of the claim.

In the fact situation before the Court, the appellant had stricken the payment in full language from a check, negotiated the instrument, and brought a claim for an alleged balance due. Under former Article 3 this was the equivalent of negotiating under protest. It does not work today.

***M. A. Walker Co., Inc. v. PBK Bank, Inc.*, (Ky. App., 95 S.W.3d, 70, (December 27, 2002))**

The Court of Appeals ruled in favor of the bank, as issuer of a letter of credit, against *Walker's* claims to seek recovery as a third party beneficiary on the letter of credit issued by the bank in favor of the Madison County Fiscal Court. The Court correctly applied the definitional sections of Article 5 to find that *Walker* did not meet the statutory definition of "beneficiary" of a letter of credit, and that if it was not named as a beneficiary it had no right to recover.

***In Re: Alabama Land and Mineral Corp., National City Bank of Kentucky v. Toffel, Trustee*, 292 F.3d 1319 (11<sup>th</sup> Cir. 2002).**

The Eleventh Circuit found that a Kentucky bank held a valid common law pledge of an uncertificated certificate of deposit and reversed the Bankruptcy Court and District Court for the

Northern District of Alabama that awarded the proceeds to a trustee in bankruptcy. National City held over a million dollars in the account as collateral for the Bank's obligation on a letter of credit that it paid for the benefit of the bankrupt debtor.

The CD was issued in receipt form as opposed to a formal certificate. However, the lower courts did not distinguish between the various forms that an account known as a CD can take. The lower courts found National City did not properly perfect its security interest because it did not take possession of an instrument; an impossibility because none had been issued. A real Catch 22 for the Bank.

National City argued that the Court should look to Revised Article 9 that recognizes CDs are not always issued in instrument form and that those not issued as instruments are deposit accounts. The Circuit Court relied on the authority of Official Comment 12 to Revised 9-102 (noting that Kentucky has adopted the Official Comments as interpretative of its UCC, KRS 355.1-110) as a clarification of the former law, found that the uncertificated CD should be classified as a deposit account, that deposit accounts were outside the scope of former Article 9, and that National City's security interest was properly taken through a common law pledge.

Deposit accounts taken as security in commercial transactions are within the scope of Revised Article 9. A security interest in a deposit account held by the secured party is automatically perfected through possession. Perfection in a deposit account held by a third party is through a control agreement or by means of the secured party becoming the customer of the depository institution.

***In Re: Kentuckiana Truck & Trailer Repair, Inc., Ralph and McKinley v. Stock Yards Bank and Trust Co., 291 BR 84, 2002 WL 32065982 (Bkrtcy. W.D. Ky. July 15, 2002).***

Owners of an interest in a business sold their interest with the debt secured by a security interest in all of the business's personal property assets. Plaintiffs perfected their security interest by filing a financing statement; however, the financing statement was filed more than three years after the date of the bank's filing on the same assets. They attacked the bank's priority based on the future advances and cross-collateralization clauses in the bank's documentation.

Plaintiffs argued that loans made by the bank subsequent to the plaintiffs' transaction with the debtor were not of the same type or class as the bank's previous loans and did not qualify as future advances for the purpose of the priority of the security interest under Kentucky's UCC. The only prior case law on this issue involved a consumer transaction and could have been interpreted as adverse to the bank's interest. However, Judge Joan Cooper found that the subsequent "loans were business loans for the purchase of inventory, working capital, the acquisition of real estate, and are not so unlike the [prior] loans [that they should be] cast as a different type or class of loan."

In view of the prior ruling, on a consumer credit fact situation, under former Article 9, this decision is an important and correct decision, under current law, on the priority of a security interest securing future advances in a commercial setting.

## **STATUS OF KENTUCKY'S UNIFORM COMMERCIAL CODE**

### **Article 1 – General Provisions**

Kentucky retains the original version of Article I, with amendments as required by revisions of other Articles. A new revised Article 1 was offered to the states in December 2001. It has been adopted in Idaho, Texas, U. S. Virgin Islands, and Virginia. It has been introduced before the legislatures of six other states. The primary purpose is to harmonize the general provisions of the Code with ongoing UCC projects and recent revisions. Until more states enact Article I, and/or there is another UCC revision project in Kentucky, it will not be adopted.

### **Article 2 – Sales**

Article 2 remains in its 1960 version (see the problem caused by the application of 2-725 in the *Barnes* case). A drafting committee has completed its efforts to revise Article 2 and a final version was approved by the National Conference of Commissioners on Uniform State Laws in 2002 and the American Law Institute in 2003. It was offered to the states in November 2003, but is not pending before any legislature.

### **Article 2A – Leases**

Kentucky adopted the 1987 text, with the 1990 amendments, in 1990. Additional drafting is underway as part of the Article 2 project but no action is expected in Kentucky.

### **Articles 3 and 4 – Negotiable Instruments, Bank Deposits and Collections**

Kentucky adopted the 1990 amendments effective January 1, 1997. Additional revisions were offered to the states in 2002 but have been adopted only by Minnesota and introduced in only Massachusetts and New York. 2002 amendments to Articles 3 and 4 provide rules for new technologies and practices in payment systems.

### **Article 5 – Letters of Credit**

Kentucky adopted Revised Article 5 as part of the Revised Article 9 drafting project, effective July 1, 2001.

### **Article 6 – Bulk Sales**

Kentucky repealed the bulk sales law in 1992. Most states have accepted the recommendation of NCCUSL and ALI for repeal, however, some have adopted an abbreviated version of the priory Article.

## **Article 7 – Documents of Title**

Revised Article 7 was offered to the states in October 2003; it has been adopted in Idaho and Virginia (effective July '04), and is pending before the legislatures of Alabama, Connecticut, Hawaii, Maryland, and Minnesota. The revision is to bring the law of documents of title into the electronic age.

## **Article 8 – Investment Securities**

Kentucky adopted the most recent revisions in conjunction with Revised Article 9 effective July 1, 2001.

## **Article 9 – Secured Transactions**

Revised Article 9 was effective in Kentucky and most other states July 1, 2001 (five states had non-uniform effective dates ranging from October 2001 through February 2002, Indiana delayed some provisions until July 1, 2002); it has been adopted by all 50 states, the District of Columbia, the U.S. Virgin Islands, but not in Puerto Rico.

## **THE SECRETARY OF STATE'S UCC FILING SYSTEM<sup>1</sup>**

On the effective date of Revised Article 9, July 1, 2001, the Secretary of State became the filing office for all UCC financing statements and amendments (including in-lieu-of continuations), other than some real estate related financing statements that remain at the county level. *See*, KRS 355.9-501.

Electronic filing became available shortly after the effective date of Revised Article 9, and is quickly becoming as popular for filers as use of the paper document.

	<u><b>Electronic Filings</b></u>	<u><b>Paper Records</b></u>
FY 2001-2002	15,894	75,175
FY 2002-2003	31,240	65,082
FY 2003-February 2004	27,057	37,893

## **COMMON ERRORS IN FILING FINANCING STATEMENTS AND AMENDMENTS**

### **Common Errors for Rejection of Paper Financing Statements**

The requirements for a financing statement are not found in a single section of Revised Article 9. The basic requirements for a financing statement, which will determine if the

---

<sup>1</sup> Data and information for this portion of the outline was supplied by Ann Clay Hanly, Supervisor of the UCC filing office for the Secretary of State.

financing statement, if filed, is sufficient, are found at KRS 355.9-502. However, additional requirements, for which the filing office may reject the filing, are found at KRS 355.9-516. The model forms, which if properly completed, are both sufficient and accepted by the filing office, are adopted; by KRS 355.9-521 and the filing office rules for the Kentucky Secretary of State. The model forms are available on the Secretary of State's website [www.kysos.com](http://www.kysos.com). (Copies of the forms and instructions for use are attached at the end of this outline.)

Most frequent reasons for rejection:

1. Debtor is an organization and items 1e, 1f, and 1g on type of organization, jurisdiction of organization, and organizational I.D. number, have not been completed.
2. The debtor's name appears in both 1a and 1b without any indication whether the debtor is an organization or individual.
3. No address is provided for the debtor.
4. An address is provided but it is not complete and omits the city, state, or zip code.
5. The financing statement is not communicated by an authorized method (use of an unofficial paper form).

If the secured party chooses electronic filing, and makes any of the errors noted above, the Secretary of State's system will not accept the electronic filing and the secured party will be immediately notified of the error and give the opportunity to correct the error.

An item that may not be corrected is the use of a d/b/a in lieu of the organization's formal name. The only proper name for an organization in a financing statement is the name as it is found in the organizing documents.

There is no provision, statutory or otherwise, for filing lengthy paper documents such as security agreements and subordination agreements in the Secretary of State's system. However you can cut and paste collateral descriptions of up to 7,000 characters into the block for collateral description on the electronic form.

If your security agreement gives you a security interest in all forms of personal property collateral, through either specific descriptions or a full list of generic descriptions recognized by Revised Article 9, the simple words "all assets" work on the financing statement. This is called a "super generic" description and should be used only on financing statements. Super generic descriptions are insufficient to describe the collateral subject to the grant of security interest.

Reasons for Rejection of Written UCC Amendments:

1. The initial financing statement being amended is not correctly identified by file number. County file numbers cannot be used! Amendment of a county file, if now required to be with the Secretary of State, is through a new initial financing statement filed in lieu of the amendment (KRS 355.9-706).
2. Amendment is filed as a debtor name change and an address is not provided for the new debtor.
3. The new debtor is an organization and the type, jurisdiction, and organizational I.D. number are not provided.
4. The amendment is filed as a combination assignment and change of secured party (blocks 4 and 5 are checked). However, an amendment provided for in either item 4 or 5 requires an address in item 7. There are similar problems from other "multiple action" filings on a single UCC amendment form. E.g., a single form indicates it is to terminate the financing statement, delete a debtor, and delete collateral. If the intent is to terminate, only block 2 is necessary. The amendment form should never be used for more than one form of amendment.

### **Electronic Forms**

See attached printouts of the available screens.

### **Use of the Secretary of State's Electronic Filing System**

**Demonstration by the Secretary of State's office.**



## UCC FINANCING STATEMENT

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]
B. SEND ACKNOWLEDGMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

**1. DEBTOR'S EXACT FULL LEGAL NAME** - insert only one debtor name (1a or 1b) - do not abbreviate or combine names

1a. ORGANIZATION'S NAME						
OR	1b. INDIVIDUAL'S LAST NAME		FIRST NAME	MIDDLE NAME	SUFFIX	
1c. MAILING ADDRESS			CITY	STATE	POSTAL CODE	COUNTRY
1d. <u>SEE INSTRUCTIONS</u>	ADD'L INFO RE ORGANIZATION DEBTOR	1e. TYPE OF ORGANIZATION	1f. JURISDICTION OF ORGANIZATION	1g. ORGANIZATIONAL ID #, if any		<input type="checkbox"/> NONE

**2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME** - insert only one debtor name (2a or 2b) - do not abbreviate or combine names

2a. ORGANIZATION'S NAME						
OR	2b. INDIVIDUAL'S LAST NAME		FIRST NAME	MIDDLE NAME	SUFFIX	
2c. MAILING ADDRESS			CITY	STATE	POSTAL CODE	COUNTRY
2d. <u>SEE INSTRUCTIONS</u>	ADD'L INFO RE ORGANIZATION DEBTOR	2e. TYPE OF ORGANIZATION	2f. JURISDICTION OF ORGANIZATION	2g. ORGANIZATIONAL ID #, if any		<input type="checkbox"/> NONE

**3. SECURED PARTY'S NAME** (or NAME of TOTAL ASSIGNEE of ASSIGNOR S/P) - insert only one secured party name (3a or 3b)

3a. ORGANIZATION'S NAME						
OR	3b. INDIVIDUAL'S LAST NAME		FIRST NAME	MIDDLE NAME	SUFFIX	
3c. MAILING ADDRESS			CITY	STATE	POSTAL CODE	COUNTRY

**4. This FINANCING STATEMENT covers the following collateral:**

5. ALTERNATIVE DESIGNATION [if applicable]:		<input type="checkbox"/> LESSEE/LESSOR	<input type="checkbox"/> CONSIGNEE/CONSIGNOR	<input type="checkbox"/> BAILEE/BAILOR	<input type="checkbox"/> SELLER/BUYER	<input type="checkbox"/> AG. LIEN	<input type="checkbox"/> NON-UCC FILING
6. <input type="checkbox"/> This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum [if applicable]		7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) [optional]		<input type="checkbox"/> All Debtors		<input type="checkbox"/> Debtor 1	<input type="checkbox"/> Debtor 2
8. OPTIONAL FILER REFERENCE DATA							

## Instructions for UCC Financing Statement (Form UCC1)

Please type or laser-print this form. Be sure it is completely legible. Read all Instructions, especially Instruction 1; correct Debtor name is crucial. Follow Instructions completely.

Fill in form very carefully; mistakes may have important legal consequences. If you have questions, consult your attorney. Filing office cannot give legal advice. Do not insert anything in the open space in the upper portion of this form; it is reserved for filing office use.

When properly completed, send Filing Office Copy, with required fee, to filing office. If you want an acknowledgment, complete item B and, if filing in a filing office that returns an acknowledgment copy furnished by filer, you may also send Acknowledgment Copy; otherwise detach. If you want to make a search request, complete item 7 (after reading Instruction 7 below) and send Search Report Copy, otherwise detach. Always detach Debtor and Secured Party Copies.

If you need to use attachments, you are encouraged to use either Addendum (Form UCC1Ad) or Additional Party (Form UCC1AP).

A. To assist filing offices that might wish to communicate with filer, filer may provide information in item A. This item is optional.

B. Complete item B if you want an acknowledgment sent to you. If filing in a filing office that returns an acknowledgment copy furnished by filer, present simultaneously with this form a carbon or other copy of this form for use as an acknowledgment copy.

1. **Debtor name:** Enter only one Debtor name in item 1, an organization's name (1a) or an individual's name (1b). Enter Debtor's exact full legal name. Don't abbreviate.
    - 1a. **Organization Debtor.** "Organization" means an entity having a legal identity separate from its owner. A partnership is an organization; a sole proprietorship is not an organization, even if it does business under a trade name. If Debtor is a partnership, enter exact full legal name of partnership; you need not enter names of partners as additional Debtors. If Debtor is a registered organization (e.g., corporation, limited partnership, limited liability company), it is advisable to examine Debtor's current filed charter documents to determine Debtor's correct name, organization type, and jurisdiction of organization.
    - 1b. **Individual Debtor.** "Individual" means a natural person; this includes a sole proprietorship, whether or not operating under a trade name. Don't use prefixes (Mr., Mrs., Ms.). Use suffix box only for titles of lineage (Jr., Sr., III) and not for other suffixes or titles (e.g., M.D.). Use married woman's personal name (Mary Smith, not Mrs. John Smith). Enter individual Debtor's family name (surname) in Last Name box, first given name in First Name box, and all additional given names in Middle Name box.  
For both organization and individual Debtors: Don't use Debtor's trade name, DBA, AKA, FKA, Division name, etc. in place of or combined with Debtor's legal name; you may add such other names as additional Debtors if you wish (but this is neither required nor recommended).
  - 1c. An address is always required for the Debtor named in 1a or 1b.
  - 1d. Reserved for Financing Statements to be filed in North Dakota or South Dakota only. If this Financing Statement is to be filed in North Dakota or South Dakota, the Debtor's taxpayer identification number (tax ID#) — social security number or employer identification number must be placed in this box.
  - 1e,f,g. "Additional information re organization Debtor" is always required. Type of organization and jurisdiction of organization as well as Debtor's exact legal name can be determined from Debtor's current filed charter document. Organizational ID #, if any, is assigned by the agency where the charter document was filed; this is different from tax ID #; this should be entered preceded by the 2-character U.S. Postal identification of state of organization if one of the United States (e.g., CA12345, for a California corporation whose organizational ID # is 12345); if agency does not assign organizational ID #, check box in item 1g indicating "none."
- Note:** If Debtor is a trust or a trustee acting with respect to property held in trust, enter Debtor's name in item 1 and attach Addendum (Form UCC1Ad) and check appropriate box in item 17. If Debtor is a decedent's estate, enter name of deceased individual in item 1b and attach Addendum (Form UCC1Ad) and check appropriate box in item 17. If Debtor is a transmitting utility or this Financing Statement is filed in connection with a Manufactured-Home Transaction or a Public-Finance Transaction as defined in applicable Commercial Code, attach Addendum (Form UCC1Ad) and check appropriate box in item 18.
2. If an additional Debtor is included, complete item 2, determined and formatted per Instruction 1. To include further additional Debtors, attach either Addendum (Form UCC1Ad) or Additional Party (Form UCC1AP) and follow Instruction 1 for determining and formatting additional names.
  3. Enter information for Secured Party or Total Assignee, determined and formatted per Instruction 1. To include further additional Secured Parties, attach either Addendum (Form UCC1Ad) or Additional Party (Form UCC1AP) and follow Instruction 1 for determining and formatting additional names. If there has been a total assignment of the Secured Party's interest prior to filing this form, you may either (1) enter Assignor S/P's name and address in item 3 and file an Amendment (Form UCC3) [see item 5 of that form]; or (2) enter Total Assignee's name and address in item 3 and, if you wish, also attaching Addendum (Form UCC1Ad) giving Assignor S/P's name and address in item 12.
  4. Use item 4 to indicate the collateral covered by this Financing Statement. If space in item 4 is insufficient, put the entire collateral description or continuation of the collateral description on either Addendum (Form UCC1Ad) or other attached additional page(s).
  5. If filer desires (at filer's option) to use titles of lessee and lessor, or consignee and consignor, or seller and buyer (in the case of accounts or chattel paper), or bailee and bailor instead of Debtor and Secured Party, check the appropriate box in item 5. If this is an agricultural lien (as defined in applicable Commercial Code) filing or is otherwise not a UCC security interest filing (e.g., a tax lien, judgment lien, etc.), check the appropriate box in item 5, complete items 1-7 as applicable and attach any other items required under other law.
  6. If this Financing Statement is filed as a fixture filing or if the collateral consists of timber to be cut or as-extracted collateral, complete items 1-5, check the box in item 6, and complete the required information (items 13, 14 and/or 15) on Addendum (Form UCC1Ad).
  7. This item is optional. Check appropriate box in item 7 to request Search Report(s) on all or some of the Debtors named in this Financing Statement. The Report will list all Financing Statements on file against the designated Debtor on the date of the Report, including this Financing Statement. There is an additional fee for each Report. If you have checked a box in item 7, file Search Report Copy together with Filing Officer Copy (and Acknowledgment Copy). Note: Not all states do searches and not all states will honor a search request made via this form; some states require a separate request form.
  8. This item is optional and is for filer's use only. For filer's convenience of reference, filer may enter in item 8 any identifying information (e.g., Secured Party's loan number, law firm file number, Debtor's name or other identification, state in which form is being filed, etc.) that filer may find useful.

## UCC FINANCING STATEMENT ADDENDUM

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

### 9. NAME OF FIRST DEBTOR (1a or 1b) ON RELATED FINANCING STATEMENT

9a. ORGANIZATION'S NAME		
OR		
9b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME, SUFFIX

10. MISCELLANEOUS:

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

### 11. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME - insert only one name (11a or 11b) - do not abbreviate or combine names

11a. ORGANIZATION'S NAME				
OR				
11b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX	
11c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY
11d. <u>SEE INSTRUCTIONS</u>	ADD'L INFO RE ORGANIZATION DEBTOR	11e. TYPE OF ORGANIZATION	11f. JURISDICTION OF ORGANIZATION	11g. ORGANIZATIONAL ID #, if any
				<input type="checkbox"/> NONE

### 12. ☐ ADDITIONAL SECURED PARTY'S or ☐ ASSIGNOR S/P'S NAME - insert only one name (12a or 12b)

12a. ORGANIZATION'S NAME				
OR				
12b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX	
12c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

13. This FINANCING STATEMENT covers ☐ timber to be cut or ☐ as-extracted collateral, or is filed as a ☐ fixture filing.

14. Description of real estate:

16. Additional collateral description:

15. Name and address of a RECORD OWNER of above-described real estate (if Debtor does not have a record interest):

17. Check only if applicable and check only one box.

Debtor is a ☐ Trust or ☐ Trustee acting with respect to property held in trust or ☐ Decedent's Estate

18. Check only if applicable and check only one box.

- ☐ Debtor is a TRANSMITTING UTILITY
- ☐ Filed in connection with a Manufactured-Home Transaction — effective 30 years
- ☐ Filed in connection with a Public-Finance Transaction — effective 30 years

### **Instructions for UCC Financing Statement Addendum (Form UCC1Ad)**

9. Insert name of first Debtor shown on Financing Statement to which this Addendum relates, exactly as shown in item 1 of Financing Statement.
10. Miscellaneous: Under certain circumstances, additional information not provided on Financing Statement may be required. Also, some states have non-uniform requirements. Use this space to provide such additional information or to comply with such requirements; otherwise, leave blank.
11. If this Addendum adds an additional Debtor, complete item 11 in accordance with Instruction 1 of Financing Statement. To include further additional Debtors, attach either an additional Addendum (Form UCC1Ad) or Additional Party (Form UCC1AP) and follow Instruction 1 of Financing Statement for determining and formatting additional names.
12. If this Addendum adds an additional Secured Party, complete item 12 in accordance with Instruction 3 of Financing Statement. To include further additional Secured Parties, attach either an additional Addendum (Form UCC1Ad) or Additional Party (Form UCC1AP) and follow Instruction 1 of Financing Statement for determining and formatting additional names. In the case of a total assignment of the Secured Party's interest before the filing of this Financing Statement, if filer has given the name and address of the Total Assignee in item 3 of Financing Statement, filer may give the Assignor S/P's name and address in item 12.
- 13-15. If collateral is timber to be cut or as-extracted collateral, or if this Financing Statement is filed as a fixture filing, check appropriate box in item 13; provide description of real estate in item 14; and, if Debtor is not a record owner of the described real estate, also provide, in item 15, the name and address of a record owner. Also provide collateral description in item 4 of Financing Statement. Also check box 6 on Financing Statement. Description of real estate must be sufficient under the applicable law of the jurisdiction where the real estate is located.
16. Use this space to provide continued description of collateral, if you cannot complete description in item 4 of Financing Statement.
17. If Debtor is a trust or a trustee acting with respect to property held in trust or is a decedent's estate, check the appropriate box.
18. If Debtor is a transmitting utility or if the Financing Statement relates to a Manufactured-Home Transaction or a Public-Finance Transaction as defined in the applicable Commercial Code, check the appropriate box.

## UCC FINANCING STATEMENT AMENDMENT

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1a. INITIAL FINANCING STATEMENT FILE #

1b. This FINANCING STATEMENT AMENDMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS.

2. ☐ **TERMINATION:** Effectiveness of the Financing Statement identified above is terminated with respect to security interest(s) of the Secured Party authorizing this Termination Statement.

3. ☐ **CONTINUATION:** Effectiveness of the Financing Statement identified above with respect to security interest(s) of the Secured Party authorizing this Continuation Statement is continued for the additional period provided by applicable law.

4. ☐ **ASSIGNMENT** (full or partial): Give name of assignee in item 7a or 7b and address of assignee in item 7c; and also give name of assignor in item 9.

5. **AMENDMENT (PARTY INFORMATION):** This Amendment affects ☐ Debtor or ☐ Secured Party of record. Check only one of these two boxes.

Also check one of the following three boxes and provide appropriate information in items 6 and/or 7.

☐ **CHANGE** name and/or address: Please refer to the detailed instructions in regards to changing the name/address of a party.

☐ **DELETE** name: Give record name to be deleted in item 6a or 6b.

☐ **ADD** name: Complete item 7a or 7b, and also item 7c; also complete items 7e-7g (if applicable).

6. **CURRENT RECORD INFORMATION:**

6a. ORGANIZATION'S NAME

OR  
6b. INDIVIDUAL'S LAST NAME FIRST NAME MIDDLE NAME SUFFIX

7. **CHANGED (NEW) OR ADDED INFORMATION:**

7a. ORGANIZATION'S NAME

OR  
7b. INDIVIDUAL'S LAST NAME FIRST NAME MIDDLE NAME SUFFIX

7c. MAILING ADDRESS CITY STATE POSTAL CODE COUNTRY

7d. **SEE INSTRUCTIONS** ADD'L INFO RE ORGANIZATION DEBTOR 7e. TYPE OF ORGANIZATION 7f. JURISDICTION OF ORGANIZATION 7g. ORGANIZATIONAL ID #, if any ☐ NONE

8. **AMENDMENT (COLLATERAL CHANGE):** check only one box.

Describe collateral ☐ deleted or ☐ added, or give entire ☐ restated collateral description, or describe collateral ☐ assigned.

9. **NAME OF SECURED PARTY OF RECORD AUTHORIZING THIS AMENDMENT** (name of assignor, if this is an Assignment). If this is an Amendment authorized by a Debtor which adds collateral or adds the authorizing Debtor, or if this is a Termination authorized by a Debtor, check here ☐ and enter name of **DEBTOR** authorizing this Amendment.

9a. ORGANIZATION'S NAME

OR  
9b. INDIVIDUAL'S LAST NAME FIRST NAME MIDDLE NAME SUFFIX

10. **OPTIONAL FILER REFERENCE DATA**

## Instructions for UCC Financing Statement Amendment (Form UCC3)

Please type or laser-print this form. Be sure it is completely legible. Read all Instructions, especially Instruction 1a; correct file number of initial financing statement is crucial. Follow Instructions completely.

Fill in form very carefully; mistakes may have important legal consequences. If you have questions, consult your attorney. Filing office cannot give legal advice. Do not insert anything in the open space in the upper portion of this form; it is reserved for filing office use.

An Amendment may relate to only one financing statement. Do not enter more than one file number in item 1a.

When properly completed, send Filing Office Copy, with required fee, to filing office. If you want an acknowledgment, complete item B and, if filing in a filing office that returns an acknowledgment copy furnished by filer, you may also send Acknowledgment Copy, otherwise detach. Always detach Debtor and Secured Party Copies.

If you need to use attachments, you are encouraged to use either Amendment Addendum (Form UCC3Ad) or Amendment Additional Party (Form UCC3AP).

Always complete items 1a and 9.

A. To assist filing offices that might wish to communicate with filer, filer may provide information in item A. This item is optional.

B. Complete item B if you want an acknowledgment sent to you. If filing in a filing office that returns an acknowledgment copy furnished by filer, present simultaneously with this form a carbon or other copy of this form for use as an acknowledgment copy.

1a. **File number:** Enter file number of initial financing statement to which this Amendment relates. Enter only one file number. In some states, the file number is not unique; in those states, also enter in item 1a, after the file number, the date that the initial financing statement was filed.

1b. Only if this Amendment is to be filed or recorded in the real estate records, check box 1b and also, in item 13 of Amendment Addendum, enter Debtor's name, in proper format exactly identical to the format of item 1 of financing statement, and name of record owner if Debtor does not have a record interest.

**Note:** Show purpose of this Amendment by checking box 2, 3, 4, 5 (in item 5 you must check two boxes) or 8; also complete items 6, 7 and/or 8 as appropriate. Filer may use this Amendment form to simultaneously accomplish both data changes (items 4, 5, and/or 8) and a Continuation (item 3), although in some states filer may have to pay a separate fee for each purpose.

2. To terminate the effectiveness of the identified financing statement with respect to security interest(s) of authorizing Secured Party, check box 2. See Instruction 9 below.

3. To continue the effectiveness of the identified financing statement with respect to security interest(s) of authorizing Secured Party, check box 3. See Instruction 9 below.

4. To assign (i) all of assignor's interest under the identified financing statement, or (ii) a partial interest in the security interest covered by the identified financing statement, or (iii) assignor's full interest in some (but not all) of the collateral covered by the identified financing statement: Check box in item 4 and enter name of assignee in item 7a if assignee is an organization, or in item 7b, formatted as indicated, if assignee is an individual. Complete 7a or 7b, but not both. Also enter assignee's address in item 7c. Also enter name of assignor in item 9. If partial Assignment affects only some (but not all) of the collateral covered by the identified financing statement, filer may check appropriate box in item 8 and indicate affected collateral in item 8.

5,6,7. To change the name of a party: Check box in item 5 to indicate whether this Amendment amends information relating to a Debtor or a Secured Party; also check box in item 5 to indicate that this is a name change; also enter name of affected party (current record name) in item 6a or 6b as appropriate; and enter new name (7a or 7b). If the new name refers to a Debtor complete (7c); also complete 7e-7g if 7a was completed.

5,6,7. To change the address of a party: Check box in item 5 to indicate whether this Amendment amends information relating to a Debtor or a Secured Party; also check box in item 5 to indicate that this is an address change; also enter name of affected party (current record name) in item 6a or 6b as appropriate; and enter new address (7c) in item 7.

5,6,7. To change the name and address of a party: Check box in item 5 to indicate whether this Amendment amends information relating to a Debtor or a Secured Party; also check box in item 5 to indicate that this is a name/address change; also enter name of affected party (current record name) in items 6a or 6b as appropriate; and enter the new name (7a or 7b). If the new name refers to a Debtor complete item 7c; also complete 7e-7g if 7a was completed.

5,6. To delete a party: Check box in item 5 to indicate whether deleting a Debtor or a Secured Party; also check box in item 5 to indicate that this is a deletion of a party; and also enter name (6a or 6b) of deleted party in item 6.

5,7. To add a party: Check box in item 5 to indicate whether adding a Debtor or Secured Party; also check box in item 5 to indicate that this is an addition of a party and enter the new name (7a or 7b). If the new name refers to a Debtor complete item 7c; also complete 7e-7g if 7a was completed. To include further additional Debtors or Secured Parties, attach Amendment Additional Party (Form UCC3AP), using correct name format.

**Note:** The preferred method for filing against a new Debtor (an individual or organization not previously of record as a Debtor under this file number) is to file a new Financing Statement (UCC1) and not an Amendment (UCC3).

7d. Reserved for Financing Statement Amendments to be filed in North Dakota or South Dakota only. If this Financing Statement Amendment is to be filed in North Dakota or South Dakota, the Debtor's taxpayer identification number (tax ID#) — social security number or employer identification number must be placed in this box.

8. Collateral change. To change the collateral covered by the identified financing statement, describe the change in item 8. This may be accomplished either by describing the collateral to be added or deleted, or by setting forth in full the collateral description as it is to be effective after the filing of this Amendment, indicating clearly the method chosen (check the appropriate box). If the space in item 8 is insufficient, use item 13 of Amendment Addendum (Form UCC3Ad). A partial release of collateral is a deletion. If, due to a full release of all collateral, filer no longer claims a security interest under the identified financing statement, check box 2 (Termination) and not box 8 (Collateral Change). If a partial assignment consists of the assignment of some (but not all) of the collateral covered by the identified financing statement, filer may indicate the assigned collateral in item 8, check the appropriate box in item 8, and also comply with instruction 4 above.

9. Always enter name of party of record authorizing this Amendment; in most cases, this will be a Secured Party of record. If more than one authorizing Secured Party, give additional name(s), properly formatted, in item 13 of Amendment Addendum (Form UCC3Ad). If the indicated financing statement refers to the parties as lessee and lessor, or consignee and consignor, or seller and buyer, instead of Debtor and Secured Party, references in this Amendment shall be deemed likewise so to refer to the parties. If this is an assignment, enter assignor's name. If this is an Amendment authorized by a Debtor that adds collateral or adds a Debtor, or if this is a Termination authorized by a Debtor, check the box in item 9 and enter the name, properly formatted, of the Debtor authorizing this Amendment, and, if this Amendment or Termination is to be filed or recorded in the real estate records, also enter, in item 13 of Amendment Addendum, name of Secured Party of record.

10. This item is optional and is for filer's use only. For filer's convenience of reference, filer may enter in item 10 any identifying information (e.g., Secured Party's loan number, law firm file number, Debtor's name or other identification, state in which form is being filed, etc.) that filer may find useful.

UCC FINANCING STATEMENT AMENDMENT ADDENDUM

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

11. INITIAL FINANCING STATEMENT FILE # (same as item 1a on Amendment form)

12. NAME OF PARTY AUTHORIZING THIS AMENDMENT (same as item 9 on Amendment form)		
12a. ORGANIZATION'S NAME		
OR		
	12b. INDIVIDUAL'S LAST NAME	FIRST NAME
		MIDDLE NAME, SUFFIX

13. Use this space for additional information

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

## **Instructions for National UCC Financing Statement AMENDMENT Addendum (Form UCC3Ad)**

11. Enter information exactly as given in item 1a on Amendment form.
12. Enter information exactly as given in item 9 on Amendment form.
13. If space on Amendment form is insufficient or you must provide additional information, enter additional information in item 13.





# KENTUCKY SECRETARY OF STATE

Trey Grayson

*"Making Kentucky Business-Friendly and Government User-Friendly."*

Secretary of State Home

UCC Filing

UCC Search

Prepaid Account Status

Friday, March 12, 2004

## Make an initial or in-lieu UCC filing

When checking your filing, we insure that the fields are complete. We do not, however, validate the **contents** of those fields. Please verify the data you have entered before clicking on the FILE button, which is at the bottom of this form.

### Debtor 1

Enter the debtor's **exact full legal name**. Use either line 1a or 1b, but not both. Do not abbreviate or combine names. The mailing address, city, state and postal code are all required. If an organization name is entered in 1a, all of 1e, 1f, and 1g must be completed.

1a. Organization's Name					
OR	1b. Individual's Last Name		First Name	Middle Name	Suffix
1c. Mailing Address		City	State	Postal Code	Country
Add'l info re organization debtor	1e. Type of organization	1f. Jurisdiction of organization	1g. organization ID#, if any		
			<input type="checkbox"/> No org ID#		

### Debtor 2

Enter an additional debtor's **exact full legal name**. Use either line 2a or 2b, but not both. Do not abbreviate or combine names. The mailing address, city, state and postal code are all required. If an organization name is entered in 2a, all of 2e, 2f, and 2g must be completed.

2a. Organization's Name					
OR	2b. Individual's Last Name		First Name	Middle Name	Suffix
2c. Mailing Address		City	State	Postal Code	Country
Add'l info re organization debtor	2e. Type of organization	2f. Jurisdiction of organization	2g. organization ID#, if any		
			<input type="checkbox"/> No org ID#		

### Debtor 3

Enter an additional debtor's **exact full legal name**. Use either line 3a or 3b, but not both. Do not abbreviate or combine names. The mailing address, city, state and postal code are all required. If an organization name is entered in 3a, all of 3e, 3f, and 3g must be completed.

3a. Organization's Name

OR

3b. Individual's Last Name

First Name

Middle Name

Suffix

3c. Mailing Address

City

State

Postal Code

Country

Add'l info re  
organization  
debtor

3e. Type of organization

3f. Jurisdiction of organization

3g. organization ID#, if any

☐ No org ID#

## Secured Party 1

Enter the secured party's **exact full legal name**. Use either line 4a or 4b, but not both. Do not abbreviate or combine names. The mailing address, city, state and postal code are all required.

4a. Organization's Name

OR

4b. Individual's Last Name

First Name

Middle Name

Suffix

4c. Mailing Address

City

State

Postal Code

Country

## Secured Party 2

Enter an additional secured party's **exact full legal name**. Use either line 5a or 5b, but not both. Do not abbreviate or combine names. The mailing address, city, state and postal code are all required.

5a. Organization's Name

OR

5b. Individual's Last Name

First Name

Middle Name

Suffix

5c. Mailing Address

City

State

Postal Code

Country

## Filer

6a. Organization's Name

OR

6b. Individual's Last Name

First Name

Middle Name

Suffix

6c. Mailing Address

City

State

Postal Code

Country

## Collateral

Up to 8000 characters of collateral information may be entered in this box. For an in-lieu filing which continues or amends a statement originally filed in another jurisdiction, a restatement of the collateral is required in this field. To make an in-lieu filing, enter the information in the table below.

### In-lieu information

Click [here](#) for a discussion of in-lieu filings, which are used to continue an existing financing statement originally filed in another jurisdiction or office. Information entered in this section is stored in an additional collateral field. KRS 355.9-706(3) discusses the requirements for an in-lieu filing. Each row in the table below represents a single previous financing statement.

1. Previous Jurisdiction	2. Previous Initial File Number	3. Previous Initial File Date and Time	If a continuation was filed in the previous jurisdiction, complete the next two fields:	
			4. Previous most recent continuation File Number	5. Previous most recent continuation File Date and Time

### Alternative Designation

If you wish to use alternate terms for the debtor and secured party, check the appropriate box below.

- ☐ None
- ☐ Lessee / Lessor
- ☐ Consignee / Consignor
- ☐ Bailee / Bailor
- ☐ Seller / Buyer (of accounts / chattel paper)

### Alternate Filing Type

- ☐ None
- ☐ Agricultural Lien
- ☐ Manufactured Home
- ☐ Public Finance
- ☐ Transmitting Utility

If you have questions or comments about the UCC online services, please contact: [Ahanly@mail.sos.state.ky.us](mailto:Ahanly@mail.sos.state.ky.us)

UCC Branch  
363 C Versailles Rd., Frankfort, KY 40601  
Office:(502) 573-0265





# KENTUCKY SECRETARY OF STATE

**Trey Grayson**

*"Making Kentucky Business-Friendly and Government User-Friendly."*

[Secretary of State Home](#)

[UCC Filing](#)

[UCC Search](#)

[Prepaid Account Status](#)

Friday, March 12, 2004

## Online UCC Filing - File an Amendment

Enter the Secretary of State's file number for the filing you are amending:

- -

Filings made with the Secretary of State before July 1, 2001 have a file number consisting of a single 7-digit number. To amend one of these filings, enter the number below:

Select the type of amendment you are filing. Amendment combinations cannot be filed online:

- ☐ Continuation
- ☐ Termination
- ☐ Assignment
- ☐ Collateral Change
- ☐ Add / change debtors (Maximum of 2)
- ☐ Add / change secured party

[Continue with filing](#)

If you have questions or comments about the UCC online services, please contact: [Ahanly@mail.sos.state.ky.us](mailto:Ahanly@mail.sos.state.ky.us)

UCC Branch  
363 C Versailles Rd., Frankfort, KY 40601  
Office:(502) 573-0265

If you have questions or comments about the Secretary of State's web site, please contact:  
[webmaster@mail.sos.state.ky.us](mailto:webmaster@mail.sos.state.ky.us)

700 Capital Avenue Suite 152, State Capitol Frankfort, KY 40601  
Office:(502) 564-3490  
Fax:(502) 564-5687  
[privacy/security policy](#)



# KENTUCKY SECRETARY OF STATE

**Trey Grayson**

*"Making Kentucky Business-Friendly and Government User-Friendly."*

Secretary of State Home

UCC Filing

UCC Search

Prepaid Account Status

Friday, March 26, 2004

## Online UCC Filing - File an Amendment

### Your Filing could not be made for the following reasons:

**This filing can't be continued at this time. The six month window for filing this continuation is from 10/27/2007 to 4/24/2008**

Enter the Secretary of State's file number for the filing you are amending:

Filings made with the Secretary of State before July 1, 2001 have a file number consisting of a single 7-digit number. To amend one of these filings, enter the number below:

Select the type of amendment you are filing. Amendment combinations cannot be filed online:

- ☒ Continuation
- ☐ Termination
- ☐ Assignment
- ☐ Collateral Change
- ☐ Add / change debtors (Maximum of 2)
- ☐ Add / change secured party

[Continue with filing](#)

If you have questions or comments about the UCC online services, please contact: [Ahanly@mail.sos.state.ky.us](mailto:Ahanly@mail.sos.state.ky.us)

UCC Branch  
363 C Versailles Rd., Frankfort, KY 40601  
Office: (502) 573-0265

If you have questions or comments about the Secretary of State's web site, please contact:  
[webmaster@mail.sos.state.ky.us](mailto:webmaster@mail.sos.state.ky.us)



# KENTUCKY SECRETARY OF STATE

**Trey Grayson**

*"Making Kentucky Business-Friendly and Government User-Friendly."*

Secretary of State Home

UCC Filing

UCC Search

Prepaid Account Status

Friday, March 26, 2004

## File a Termination

Click on the Terminate button below to file a termination for

### Secured Party of Record authorizing this filing

6a. Organization's Name

or

6b. Individual's Last Name

First Name

Middle Name

Suffix

### Filer

6a. Organization's Name

or

6b. Individual's Last Name

First Name

Middle Name

Suffix

6c. Mailing Address

City

State

Postal Code

Country

**Terminate**

If you have questions or comments about the UCC online services, please contact: [Ahanly@mail.sos.state.ky.us](mailto:Ahanly@mail.sos.state.ky.us)

UCC Branch  
363 C Versailles Rd., Frankfort, KY 40601  
Office:(502) 573-0265

If you have questions or comments about the Secretary of State's web site, please contact:  
[webmaster@mail.sos.state.ky.us](mailto:webmaster@mail.sos.state.ky.us)

700 Capital Avenue Suite 152, State Capitol Frankfort, KY 40601  
Office:(502) 564-3490  
Fax:(502) 564-5687  
[privacy/security policy](#)



# KENTUCKY SECRETARY OF STATE

**Trey Grayson**

*"Making Kentucky Business-Friendly and Government User-Friendly."*

Secretary of State Home

UCC Filing

UCC Search

Prepaid Account Status

## Online Filing Assignment

Click on the Assign button below to file an assignment for

### Assignee

Enter the assignee's **exact full legal name**. Use either line 1a or 1b, but not both. Do not abbreviate or combine names. The mailing address, city, state and postal code are all required.

Friday, March 26, 2004

1a. Organization's Name

OR

1b. Individual's Last Name

First Name

Middle Name

Suffix

1c. Mailing Address

City

State

Postal Code

Country

### Assignor

1a. Organization's Name

OR

1b. Individual's Last Name

First Name

Middle Name

Suffix

### Filer

6a. Organization's Name

OR

6b. Individual's Last Name

First Name

Middle Name

Suffix

6c. Mailing Address

City

State

Postal Code

Country

**Assign**

If you have questions or comments about the UCC online services, please contact: [Ahanly@mail.sos.state.ky.us](mailto:Ahanly@mail.sos.state.ky.us)

UCC Branch  
363 C Versailles Rd., Frankfort, KY 40601  
Office:(502) 573-0265





# KENTUCKY SECRETARY OF STATE

**Trey Grayson**

*"Making Kentucky Business-Friendly and Government User-Friendly."*

[Secretary of State Home](#)

[UCC Filing](#)

[UCC Search](#)

[Prepaid Account Status](#)

Friday, March 12, 2004

## Collateral Change Amendment

Click on the Amend button below to file an amendment modifying the collateral for

### Type of Collateral Change

☒ Add      ☐ Change      ☐ Delete      ☐ Restate      ☐ Assign

### Collateral

Up to 8000 characters of collateral information may be entered in this box.

### Secured Party of Record authorizing this amendment

1a. Organization's Name

OR

1b. Individual's Last Name

First Name

Middle Name

Suffix

### Filer

6a. Organization's Name

OR

6b. Individual's Last Name

First Name

Middle Name

Suffix

5c. Mailing Address

City

State

Postal Code

Country

**Amend**

If you have questions or comments about the UCC online services, please contact: [Ahanly@mail.sos.state.ky.us](mailto:Ahanly@mail.sos.state.ky.us)



# **HIPAA AND FINANCIAL INSTITUTIONS**

*Vickie Yates Brown  
Greenebaum Doll & McDonald PLLC  
Louisville, Kentucky*

Copyright 2004. Vickie Yates Brown. All Rights Reserved.

## **SECTION I**

## **HIPAA AND FINANCIAL INSTITUTIONS**

April 16, 2004

Vickie Yates Brown  
Chair, Health Care and Insurance Practice Group  
Co-Chair of Privacy and BioTech Task Forces  
Greenebaum Doll & McDonald, PLLC  
3500 National City Tower  
Louisville, Kentucky 40202  
502-587-3578  
Fax: 502-540-2171  
E-mail: [vyb@gdm.com](mailto:vyb@gdm.com)

## **HIPAA AND FINANCIAL INSTITUTIONS**

<b>PART I.</b>	<b>HIPAA OVERVIEW .....</b>	<b>I-1</b>
I.	Who Must Comply? .....	I-2
A.	Covered Entities .....	I-2
i.	Electronic .....	I-2
ii.	Transaction .....	I-2
B.	Business Associates .....	I-3
II.	What Is Protected?	
A.	Protected Health Information .....	I-4
B.	De-Identified Information .....	I-4
III.	When Must A Covered Entity Comply? .....	I-5
IV.	What Does The Regulation Require? .....	I-5
A.	Permitted Uses And Disclosures Of PHI .....	I-5
1.	Treatment, Payment and Health Care Operations .....	I-6
2.	Authorization .....	I-6
3.	Psychotherapy Notes .....	I-9
B.	Minimum Necessary Standard .....	I-11
C.	Business Associate Agreements .....	I-12
D.	Directories, Marketing And Fundraising .....	I-14
E.	Research .....	I-15
F.	Patient Rights And Protections .....	I-17
G.	Administrative Requirements .....	I-20

### **SECTION I**

V.	State Law Pre-Emption .....	I-21
VI.	Violations (or, why comply?) .....	I-22
<b>PART II.</b>	<b>HIPAA AND FINANCIAL INSTITUTIONS .....</b>	<b>I-23</b>
A.	When Is A Bank A “Healthcare Clearinghouse” Under HIPAA? .....	I-23
B.	When Is A Bank A “Business Associate” Under HIPAA? .....	I-35
<b>CONCLUSION</b> .....		<b>I-40</b>
 <b>APPENDIX:</b>		
1.	NACHA - The Electronic Payments Association White Paper On HIPAA Related Issues Affecting The Bankruptcy Industry, Revised July, 2003 .....	I-41
2.	HIPAA Conformance Certification Organization: HIPAA Medical Banking .....	I-69
3.	HIPAA Application To The Banking Industry .....	I-71
4.	Memorandum From Morrison & Forester LLP To Ian Macoy at NACHA Regarding Application of HIPAA Rules to Receiving Depository Financial Institutions, March 19, 2003 .....	I-77
5.	Guidance Letter From Mark L. Stember of Kilpatrick Stockton LLP To Debra K. Stamper, General Counsel, Kentucky Bankers Association, April 20, 2003, Regarding Lockbox Services Under the HIPAA Privacy Rules .....	I-83

## SECTION I

## **PART I. HIPAA OVERVIEW**

Although the confidentiality of patient records has long been the subject of a patchwork of state and federal statutes and regulations, the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), promulgated by the U.S. Department of Health and Human Services ("HHS") for the first time established a comprehensive, national medical privacy statute. HIPAA is actually comprised of 5 titles, each of which regulates a different aspect of health care. The privacy, security and transaction standards of HIPAA are the regulations promulgated under Subtitle F of Title II, known as the Act's "Administrative Simplification" provisions.<sup>1</sup>

The HIPAA rules are part of a wave of state, federal and even international governmental activity aimed at protecting the privacy of consumers in an age when personal information is being transmitted by businesses with unprecedented ease and efficiency. Consumer privacy fears are particularly strong regarding medical records, which are among the most confidential of all types of information. These fears have been heightened by the explosion of Internet-based health care companies, the increased availability of genetic information and the growing use of electronic communication technologies by health care organizations for the exchange of medical data. In an effort to allay these concerns, the HIPAA rules require a major change in the way health care organizations and companies that service them do business. Congress articulated three purposes for the regulations promulgated under the HIPAA Administrative Simplification provisions:

1. "To protect and enhance the rights of consumers by providing them access to their health information and controlling the inappropriate use of that information." 65 Fed. Reg. 82462, 82463 (Dec. 28, 2000).
2. To improve the quality of care "by restoring trust in the system" among consumers, providers and others involved in the delivery of care; *Id.* and
3. "To improve the efficiency and effectiveness of health care delivery by creating a national framework for health privacy protection." *Id.*

---

<sup>1</sup>I wish to thank Tate M. Bombard, an associate in the Greenebaum Doll & McDonald PLLC, Health Care and Insurance Practice Group, who assisted me in preparing all the materials for this seminar.

the regulation and what information is protected by the Privacy Rule are the first steps to being able to comply with HIPAA.

**I. Who must comply?**

**A. Covered Entities:** The Final Privacy Rule applies to three types of health care organizations, referred to as “covered entities” in the regulations:

1. **Health plans** (for example, employee welfare benefit plans, health insurance issuers, health maintenance organizations);
2. **health care clearinghouses** (for example, re-pricing companies, billing companies, value-added networks); and
3. **health care providers** (for example, doctors, hospitals, home health agencies).

Covered entities, however, are only covered if they (1) transmit any health information in *electronic form* (2) in connection with a *transaction* covered by HIPAA.

**i. Electronic:** At first glance it may appear that this last requirement is a loophole for those not wanting to undertake HIPAA compliance. In reality, though, in a time when almost everything is done electronically, and “electronic” encompasses not just transmission by desk-top computers but also palm pilots, laptop computers, faxes, PDAs and the myriad of other electronic devices available, the vast majority of health care providers will, at some time, “transmit health information in electronic form.” Even one transmission, for example submitting a claim to a patient’s insurance, will subject you to the mandates of the Privacy Rule.

**ii. Transaction:** Transactions under HIPAA means the transmission of information between two parties to carry out financial or administrative activities related to health care. It includes the following types of information transmissions:

1. Health care claims or equivalent encounter information;
2. Health care payment and remittance advice;
3. Coordination of benefits;
4. Enrollment and disenrollment in a health plan;
5. Eligibility for a health plan;
6. Health plan premium payments;
7. Referral certification and authorization;



The basic requirement of the Final Privacy Rule is simply stated as follows: "A Covered Entity may not use or disclose an individual's protected health information, except as otherwise permitted or required by the regulation." Fully understanding the definition of who is effected by the regulation and what information is protected by the Privacy Rule are the first steps to being able to comply with HIPAA.

**I. Who must comply?**

**A. Covered Entities:** The Final Privacy Rule applies to three types of health care organizations, referred to as "covered entities" in the regulations:

1. **Health plans** (for example, employee welfare benefit plans, health insurance issuers, health maintenance organizations);
2. **health care clearinghouses** (for example, re-pricing companies, billing companies, value-added networks); and
3. **health care providers** (for example, doctors, hospitals, home health agencies).

Covered entities, however, are only covered if they (1) transmit any health information in *electronic form* (2) in connection with a *transaction* covered by HIPAA.

**i. Electronic:** At first glance it may appear that this last requirement is a loophole for those not wanting to undertake HIPAA compliance. In reality, though, in a time when almost everything is done electronically, and "electronic" encompasses not just transmission by desk-top computers but also palm pilots, laptop computers, faxes, PDAs and the myriad of other electronic devices available, the vast majority of health care providers will, at some time, "transmit health information in electronic form." Even one transmission, for example submitting a claim to a patient's insurance, will subject you to the mandates of the Privacy Rule.

**ii. Transaction:** Transactions under HIPAA means the transmission of information between two parties to carry out financial or administrative activities related to health care. It includes the following types of information transmissions:

1. Health care claims or equivalent encounter information;
2. Health care payment and remittance advice;
3. Coordination of benefits;
4. Enrollment and disenrollment in a health plan;

8. First report of injury;
9. Health claims attachments; and
10. Other transactions that the Secretary may prescribe.

If you are a health care provider, a health plan or a health care clearinghouse and you transmit *any* of the preceding information electronically, you are considered a Covered Entity under HIPAA.

**B. Business Associates:** Covered entities are bound by HIPAA's privacy standards, whether they conduct their business affairs themselves or through third parties (known in the Final Privacy Rule as "Business Associates") who perform some of their essential functions. Furthermore, even if you are not a Covered Entity under the rule, there is a good chance that you may be considered a Business Associate of a Covered Entity.

1. A Business Associate is a person or entity who provides certain functions, activities, or services for or to a Covered Entity, involving the use and/or disclosure of PHI.
2. A Business Associate is not a member of the health care provider, health plan, or other Covered Entity's workforce.
3. A health care provider, health plan, or other Covered Entity can also be a Business Associate to another Covered Entity.
4. The rule includes exceptions. The Business Associate requirements do not apply to covered entities who disclose PHI to providers for treatment purposes - for example, information exchanges between a hospital and physicians with admitting privileges at the hospital.

Examples of potential Business Associate relationships include, but are not limited to, relationships with the following: billing companies, software and/or hardware vendors; waste hauling/incineration companies; temporary staffing agencies; and lawyers/law firms.

## II. What is protected?

**A. Protected Health Information:** The Final Privacy Rule applies to *protected health information* ("PHI"). Under the proposed rules, PHI was limited to electronic records and any paper records that previously existed in electronic form. In the Final Privacy Rule, PHI has been expanded to include information transmitted or maintained in any form or medium, including oral communications. PHI in any form is protected if it (1) is created or received by a Covered Entity; (2) relates to an individual's physical or mental health condition, the provision of health care to an individual or the payment for the provision of health care to an individual; and (3) identifies the individual or creates a reasonable basis to believe that the information, including demographic information, can be used to identify the individual. 45 Fed. Reg. §164.501.

**B. De-identified Information:** A Covered Entity may use PHI to create de-identified health information, which is information that does not identify an individual and where there is no reasonable basis to believe that the information can be used to identify an individual. De-identified health information *must* be created in accordance with the procedures outlined in §164.514(a) of the Final Privacy Rule. A Covered Entity demonstrates that it has met the standard outlined in the Privacy Rule either by a statistical determination of a small risk of identification or by meeting the Safe Harbor provided in the Privacy Rule which requires the removal of *all* of the following identifiers from the information:

1. Name;
2. All geographic subdivisions smaller than a State;
3. All elements of dates (except year) for dates directly related to an individual;
4. Telephone numbers;
5. Fax numbers;
6. Electronic mail addresses;
7. Social security numbers;
8. Medical record numbers;
9. Health plan beneficiary numbers;
10. Account numbers;

11. Certificate/license numbers;
12. Vehicle identifiers and serial numbers;
13. Device identifiers and serial numbers;
14. Web Universal Resource Locators (URLs);
15. Internet Protocol (IP) address numbers;
16. Biometric identifiers
17. Full face photographic images; and
18. Any other unique identifying number, characteristic, or code. *See* §164.514(b)(2)(i).

To meet the Safe Harbor you must remove this enumerated list of identifiers from the information and have **no actual knowledge** that the information could be used to identify an individual. *Id.*

### **III. When must a Covered Entity Comply?**

The HIPAA privacy regulation became effective on April 14, 2001, with an April 14, 2003, compliance date. Small health plans are allowed an additional 12 months. However, the HIPAA regulation provided the secretary of HHS with a one-year period from the effective date for modifications in the regulation and on March 27, 2002, HHS proposed certain modifications to the Final Privacy Rule. The Proposed Rule recommends some changes to the Privacy Rule. The Proposed Rule modification, however, *does not* defer the compliance deadline for the Privacy Rule which remains April 14, 2003 or April 14, 2004 for small health plans.<sup>1</sup>

### **IV. What does the regulation require?**

**A. Permitted uses and disclosures of PHI:** A Covered Entity is generally permitted to use and disclose PHI **only** (1) to the individual who is the subject of the PHI; (2) for treatment, payment or health care operations, (3) pursuant to a patient's consent or authorization; or (4) upon a patient's agreement or failure to object following an opportunity to object.

---

<sup>1</sup>The Proposed Rule can be found at 67 Fed. Reg. 14776 *et seq.*

**1. Treatment, payment and health care operations:** The Final Privacy Rule allows a covered entity to use or disclose PHI, without the individual's authorization, to carry out treatment,<sup>2</sup> payment<sup>3</sup> or health care operations<sup>4</sup> in certain circumstances. Specifically, (1) a covered entity can use or disclose PHI for its own treatment, payment, and health care operations activities; (2) a covered entity may disclose PHI for the treatment activities of any health care provider (including providers not covered by the Privacy Rule); (3) a covered entity may disclose PHI to another covered entity or a health care provider (including providers not covered by the Privacy Rule) for payment activities of the entity that receives the information; and (4) a covered entity may disclose PHI to another covered entity for certain health care operation activities of the entity that receives the information if: (a) each entity either has or had a relationship with the individual who is the subject of the information, and the PHI pertains to the relationship, and (b) the disclosure is for a quality-related health care operations activity (i.e., the activities listed in paragraphs (1) and (2) of the definition of "health care operations" at 45 C.F.R. 164.501) or for the purpose of health care fraud and abuse detection or compliance.

**2. Authorization:** Unless a specific exception applies, a Covered Entity must obtain an individual's authorization to use or disclose PHI for any reason other than treatment, payment and health care operations. §§ 164.508. Unlike the consent, a Covered Entity may not condition treatment, payment, enrollment in a health plan or eligibility for

---

<sup>2</sup>Treatment means the provision, coordination or management of health care related services by one or more health care providers, including the coordination or management of health care by a health care provider with a third party; consultation between health care providers relating to a patient; or the referral of a patient for health care from one health care provider to another. 45 C.F.R. §164.501.

<sup>3</sup>Payment means activities taken by a health plan to obtain premiums or to determine or fulfill its responsibility for coverage and provision of benefits under the health plan, or the activities of a covered health care provider or health plan to obtain or provide reimbursement for the provision of health care. Activities include, but are not limited to: determination of eligibility of coverage; risk adjustment; billing, claims management, collection activities, obtaining payment, and related health care data processing; review of health care services with respect to medical necessity, coverage under a health plan, appropriateness of care, or justification of charges; utilization review activities. 45 C.F.R. §164.501.

<sup>4</sup>Health Care Operations include a wide range of day-to-day activities that relate to the function of the health care provider. This includes, but is not limited to, activities such as quality assessment and improvement, case management and care coordination, contacting providers about care alternatives, reviewing health plan performance, accreditation, certification, licensing, credentialing, obtaining medical review, legal services, compliance activities, and business planning. 45 C.F.R. §164.501.

benefits on the signing of a specific authorization except for research related treatment, enrollment or eligibility prior to the individual's enrollment in a health plan, and payment of claims by a health plan if such disclosure is necessary and does not include psychotherapy notes.

The following core elements are required for **every valid authorization**:

1. A description of the information to be used or disclosed that identifies the information in a specific and meaningful fashion;
2. The name or other specific identification of the person(s), or class of persons, authorized to make the requested use or disclosure;
3. The name or other specific identification of the person(s), or class of persons, to whom the Covered Entity may make the requested use or disclosure;
4. An expiration date or an expiration event that relates to the individual or purpose of the use or disclosure;
5. A statement of the individual's right to revoke the authorization in writing and the exceptions to the right to revoke, together with a description of how the individual may revoke the authorization;
6. A statement that information may be used or disclosed pursuant to the authorization and may be subject to redisclosure by the recipient and no longer be protected by this rule;
7. Signature of the individual and date; and
8. If the authorization is signed by a personal representative of the individual, a description of such representative's authority to act for the individual.

In addition, if an authorization is requested by a Covered Entity for its **own use or disclosure** of PHI that it maintains, the authorization must also contain the following requirements:

1. A statement that the Covered Entity will not condition treatment, payment, enrollment in the health plan, or eligibility for benefits on the individual's providing authorization for the requested use or disclosure;
2. A description of each purpose of the requested use or disclosure;
3. A statement that the individual may:
  - a. Inspect or copy the PHI to be used or disclosed; and
  - b. Refuse to sign the authorization; and
4. If use or disclosure of the requested information will result in direct or indirect remuneration to the Covered Entity from a third party, a statement that remuneration will result.

If the authorization is requested by a Covered Entity **for disclosures by another Covered Entity** to disclose PHI to the Covered Entity requesting the authorization to carry out treatment, payment or health care operations, the authorization must also contain the following requirements:

1. A description of each purpose of the required disclosure;
2. A statement that the Covered Entity will not condition treatment, payment, enrollment in the health plan, or eligibility for benefits on the individual's providing authorization for the requested use or disclosure; and

3. A statement that the individual may refuse to sign the authorization

If the authorization is requested by a Covered Entity that creates PHI **for the purpose, in whole or in part, of research that includes treatment of individuals**, the authorization must meet the general authorization requirements and contain the following requirements:

1. A description of the extent to which such PHI will be used or disclosed to carry out treatment, payment or health care operations;
2. A reference to any consent obtained by the Covered Entity or any notice of privacy practices provided by the Covered Entity as required under HIPAA.
3. The authorization may be in the same document as:
  - a. A consent to participate in the research;
  - b. A consent to use or disclose PHI to carry out treatment, payment or health care operations; or
  - c. A notice of privacy practices.

**3. Psychotherapy notes:** A prominent exception to the consent guidelines are the requirements pertaining to the release of psychotherapy notes. Specifically, the HIPAA privacy regulation states that an organization may not release psychotherapy notes as part of normal treatment and business operations without obtaining an individual's specific *authorization*. This is counter to the implied permissions stated above for normal treatment and business operations.

The regulations define psychotherapy notes narrowly to include only *detailed notes recorded by a mental health professional documenting or analyzing the contents of conversations during a private, family or group counseling session*. Psychotherapy notes expressly do not include medication prescription and monitoring, counseling session start and



stop times or the modalities and frequencies of treatment furnished, results of clinical tests or a brief summary of diagnosis, functional status, the treatment plan, symptoms prognosis and progress to date. Most mental health records will not qualify as psychotherapy notes. For example, a note in the medical record about a mental health diagnosis, treatment plan and progress is not a psychotherapy note. Importantly however, mental health records that do not qualify as psychotherapy notes are still subject to the same privacy requirements as other PHI.

The Privacy Rule requires covered entities to obtain a special authorization for most uses and disclosures of psychotherapy notes, including:

1. For treatment purposes, if the person using or disclosing is someone other than the person who created the notes.
2. For payment or healthcare operations, regardless of who is using or disclosing the information.

Covered entities may use the general consent form to support the following uses or disclosures of psychotherapy notes:

1. Use or disclosure for treatment purposes by the person who created the psychotherapy notes (and only that person).
2. To conduct training programs in which students, trainees or practitioners in mental health learn under supervision to practice or improve their skills in group, joint, family or individual counseling.
3. To defend a legal action or other proceeding brought by the patient. Note that you are allowed to release the information to your defense attorney under this provision, but disclosures to others in the course of a judicial or administrative proceeding requires an authorization.

Neither a consent or authorization is required for the following uses and/or disclosures:

1. When required for law enforcement purposes.
2. When mandated by law.
3. When needed for oversight of the provider who created the notes.
4. When needed by a coroner or medical examiner.
5. When needed to avert a serious and imminent threat to health or safety.

In addition to the additional consent and authorization requirements, the Final Privacy Rule also requires that psychotherapy notes be maintained separately from a patient's medical record and other PHI. The separation requirement does not necessarily mean the records must be maintained in a separate file from the medical record. Rather, separating the psychotherapy notes from the rest of the medical file with a tab or other conspicuous separator will likely suffice.

HIPAA privacy generally provides a strong patient right of access to PHI that is used to make decisions about the patient. An exception is made for psychotherapy notes. The Privacy Rule allows a provider to refuse a patient access to their own psychotherapy notes, for any reason. The provider does not need to make a determination that release of the notes would be harmful to the patient and the patient does not have a right to have the denial reviewed.

#### **B. Minimum Necessary Standard**

With certain limited exceptions, when a Covered Entity uses or discloses PHI, or when requesting such information from other covered entities, the entity must make reasonable efforts to limit the information to the minimum information necessary to accomplish the intended purpose, even if the use or disclosure is occurring pursuant to a valid consent or authorization. §164.502(b). Reasonable efforts include the implementation of policies and procedures for routine, recurring disclosures, and the development of criteria against which all other disclosures are individually reviewed to be used to limit the information to that needed to achieve the stated purposes. § 164.514(d)(3).

The Final Privacy Rule does provide exceptions to the standard in that the minimum necessary standard does not apply to (1) requests by health care providers for treatment purposes, or (2) to requests by the individuals themselves. § 164.502(b)(2)(i). In addition, the Privacy Rule provides that a Covered Entity may rely, if reasonable under the circumstances, on a requested disclosure of PHI as the minimum necessary for the stated purposes if:

1. The information is requested by another Covered Entity; or
2. The information is requested by a professional who is a Business Associate of the Covered Entity for purposes of providing professional services to the Covered Entity if the professional represents that the information requested is the minimum necessary for the stated purpose. § 164.514 (d)(3)(iii).

**C. Business Associate Agreements**

The Final Privacy Rule requires all covered entities to obtain satisfactory assurance that their Business Associates will "appropriately safeguard" PHI. The Privacy Rule requires that these assurances be documented in a written contract or other written agreement with the Business Associate. Importantly, the Final Rule also imposes liability on Covered Entities if one of its Business Associates materially breaches its obligations under such contract.

A contract between the Covered Entity and a Business Associate **must**:

1. Establish the permitted and required uses and disclosures of such information by the Business Associate. The contract may not authorize the Business Associate to use or further disclose the information in a manner that would violate HIPAA privacy, if done by the Covered Entity, except that:
  - a. The contract may permit the Business Associate to use and disclose PHI for the proper management and administration of the Business Associate [see below]; and
  - b. The contract may permit the Business Associate to provide data aggregation services relating the health care operation of the Covered Entity.
2. Provide that the Business Associate will:

- a. Not use or further disclose the information other than as permitted or required by law;
- b. Use appropriate safeguards to prevent use or disclosure of PHI other than as provided for by the contract;
- c. Report to the provider any unauthorized use or disclosure of PHI of which it becomes aware;
- d. Ensure that any agents, including subcontractors, to whom it provides PHI agree to the same restrictions and conditions that apply to the Business Associate;
- e. Permit the subject of the PHI to have access to it as allowed by the Privacy regulations;
- f. Permit the subject of PHI to amend the information and incorporate the amendments in accordance with the Privacy regulations;
- g. Provide an accounting of disclosures of PHI when requested by the subject of the information in accordance with the Privacy regulations;
- h. Make its internal practices, books and records relating to PHI available to the Secretary of HHS for determining the provider's compliance with the Privacy regulations;
- i. Return or destroy all PHI at the termination of the agreement, if feasible.

3. Authorize termination of the agreement by the Covered Entity if the Business Associate violates a material term of the agreement.

A contract between the Covered Entity and a Business Associate **may**:

1. Permit the Business Associate to use and disclose PHI as necessary (1) for the proper management and administration of the Business Associate, or (2) to carry out the legal responsibilities of the Business Associate, IF
  - a. The disclosure is required by law, **or**
  - b. The Business Associate obtains reasonable assurances from the person to whom the information is disclosed that they will:
    - i. hold the information confidentially and use or disclose it only as required by law or for the purposes for which it was disclosed to them, **and**
    - ii. notify the Covered Entity of any instances of which it is aware in which the confidentiality of the PHI has been breached.

**D. Directories, Marketing and Fundraising**

A Covered Entity may disclose certain PHI without first obtaining a written authorization in order to maintain a directory of individuals in its facility or to provide information to family members or close personal friends involved in the care of the individual. The Covered Entity must inform the individual in advance, orally or in writing, of such use of PHI and offer an opportunity for the individual to prohibit or restrict the use. §§ 164.510. This rule essentially creates an "opt out" provision by which an individual has the burden of objecting to this limited use or disclosure of PHI.

Similarly, a Covered Entity may use PHI without first obtaining a written authorization for its own marketing and fundraising purposes. However, the Covered Entity must provide the individual with an opportunity to “opt out” of receiving future marketing or fundraising communications. §§164.514(e) and (f). Covered Entities should be aware that despite this exemption from the authorization requirement, the use of PHI in connection with marketing and fundraising materials must still comply with requirements specifically related to marketing and fundraising activities. For instance, marketing materials that include PHI must (1) identify that the marketing materials come from the Covered Entity and (2) state whether the Covered Entity receives compensation from a third party for the marketing. §§164.514(e)(3). Further, PHI used by Covered Entities as part of fundraising activities may only include demographic information about the individual (*i.e.*, name, address) and dates of health care service provided to such individual. §§164.514(f)(1).

#### **E. Research**

The Privacy Rule establishes the conditions under which PHI may be used or disclosed by covered entities for research purposes. Under the Privacy Rule, covered entities are permitted to use and disclose PHI for research with individual authorization, or without individual authorization under limited circumstances set forth in the Privacy Rule. Keep in mind, however, that a Covered Entity may always use or disclose for research purposes health information which has been de-identified (in accordance with §§ 164.502(d), 164.514(a)-(c) of the rule).

To use or disclose PHI ***without authorization*** by the research participant, a covered entity must obtain one of the following:

- ❑ Documentation that an alteration of the authorization or waiver of the research participants' authorization for use/disclosure of information about them for research purposes has been approved by an Institutional Review Board (IRB) or a Privacy Board. This provision of the Privacy Rule might be used, for example, to conduct records research, when researchers are unable to use de-identified information and it is not practicable to obtain research participants' authorization.
- OR

- ☐ Representations from the researcher, either in writing or orally, that the use or disclosure of the PHI is solely to prepare a research protocol or for similar purposes preparatory to research, that the researcher will not remove any PHI from the covered entity, *and* representation that PHI for which access is sought is necessary for the research purpose. This provision might be used, for example, to design a research study or to assess the feasibility of conducting a study. OR
- ☐ Representations from the researcher, either in writing or orally, that the use or disclosure being sought is solely for research on the PHI of decedents, that the PHI being sought is necessary for the research, *and*, at the request of the covered entity, documentation of the death of the individuals about whom information is being sought.

A covered entity may use or disclose PHI for research purposes pursuant to a ***waiver of authorization*** by an IRB or Privacy Board provided it has obtained documentation of *all* of the following:

- ☐ A statement that the alteration of the authorization or waiver of the authorization was approved by an IRB or Privacy Board that was composed as stipulated by the Privacy Rule;
- ☐ A statement identifying the IRB or Privacy Board and the date on which the alteration or waiver of authorization was approved;
- ☐ A statement that the IRB or Privacy Board has determined that the alteration or waiver of authorization, in whole or in part, satisfies the eight criteria designated in the regulations. *See* 45 C.F.R. §164.512(iii)(C)(2)(ii).

The Privacy Rule also permits covered entities to use and disclose PHI for research purposes when a research participant authorizes the use or disclosure of information about him or

herself. To use or disclose PHI created from a research study that includes treatment (e.g., a clinical trial), additional research-specific elements must be included in the authorization form required under §§ 164.508, which describe how PHI created for the research study will be used or disclosed. For example, if the covered entity/researcher intends to seek reimbursement from the research subject's health plan for the routine costs of care associated with the protocol, the authorization must describe types of information that will be provided to the health plan. This authorization may be combined with the traditional informed consent document used in research.

#### **F. Patient Rights and Protections**

The Final Privacy Rule also creates a new set of rights for patients with respect to PHI. The final HIPAA privacy regulations grant patients six rights in connection with their PHI. Although many states already have patients' rights laws that give patients access to their health information, the rights granted by HIPAA go far beyond what most states require.

##### **Right #1: Patients must get notice of your organization's privacy practices.**

The regulations give patients the right to get a notice describing a Covered Entity's privacy practices (hereinafter "Notice"); that is, when and why a Covered Entity uses and discloses PHI. The Notice language must be very specific and include certain provisions.

1. A Notice must give examples of PHI disclosures that the particular organization may make that do not require the patient's consent, as well as PHI disclosures that are required by law.
2. The Notice must also state that other uses and disclosures will be made only with the patient's written consent.
3. The Notice must explain that the Covered Entity has a duty to protect confidential health information, include a description of the patient's PHI rights, and have a statement describing how a patient can complain if he or she thinks a Covered Entity has violated his or her privacy rights.



If a Covered Entity wishes to make changes to its Notice from time to time, it will need to include language in it that gives it the right to do so. The regulations also mandate when a Covered Entity must update its Notice of privacy practices and how often it must give it to patients. For instance, all covered organizations must give the Notice to anyone who requests it, health plans must give it to all plan enrollees by the compliance deadline, and health care providers must give it to patients the first time health care is provided.

The Proposed Rule further strengthens the importance of the Notice requirement. In lieu of written consent (which is voluntary under the Proposed Rule) patients would be asked to acknowledge receipt of the notice of privacy rights and practices. This change is designed to give patients the opportunity to consider a provider's privacy policies before making health care decisions, while potentially eliminating barriers that could delay or block patients' access to care.

**Right #2: Patients may request restrictions on disclosures to others of their protected health information.**

Patients have the right to request restrictions on covered entities' use and disclosure of their PHI. For example, a patient could ask his or her physician not to disclose any of his or her PHI to his or her sibling. The regulations say that a health care organization must allow a patient to request a restriction, but that the organization doesn't have to grant the request. If the organization agrees to the patient's request, it must then document the restriction through written or electronic records and comply with it. But if an organization wants to deny a request after considering it, it can do so for any reason.

**Right #3: Patients may request alternative means of communicating protected health information.**

Patients have the right to ask a Covered Entity to communicate their PHI by alternative means (that is, by other than the method the Covered Entity typically uses) or to alternative locations. For example, a patient may request that any written correspondence from his or her doctor (such as appointment reminders, test results, and bills) that are normally mailed to his or

her home address, instead be faxed to him or her at work. If a covered health entity is a health care provider, you must agree to the patient's request if it is reasonable and if it is not too difficult for the Covered Entity to administer. The requirement is slightly different for health plans. The regulations say that health plans must grant such requests only if the patient states that the disclosure of the PHI "could endanger the individual." Once the patient makes the statement, the health plan must accommodate the request. The patient need not give the health plan the details of the potential danger.

**Right #4: Patients may inspect and get a copy of their protected health information.**

One of the broadest rights given to patients by the final regulations is the right of access to their PHI. Health care organizations must allow patients to inspect and get a copy of their PHI from the organization. Although there are limited exceptions to the rule, for instance access to psychotherapy notes may be denied, in general, a Covered Entity will have to give access to PHI to the patient within 30 days of getting the patient's request. The regulations also specify what records are covered by the access right and must be provided, the form of the records, the timing for access, and the fees charged. For example, a Covered Entity can charge a reasonable cost-based fee for copying, postage, or preparation of the PHI. If a Covered Entity denies the patient's request for access, the Covered Entity must, in most cases, (1) say why, (2) give the patient a right to a review by the Covered Entity of its denial, and (3) tell the patient how to complain to the organization or to the Department of Health and Human Services about the denial. The regulations also set out a procedure and time frame that the Covered Entity must follow for the review process.

**Right #5: Patients may request amendments to their protected health information.**

Patients also have the right to request that their PHI be amended or corrected. A Covered Entity must respond to each request within 60 days of getting such a request. A Covered Entity may deny the request if the PHI is accurate and complete, or if a Covered Entity didn't create the

PHI. If a Covered Entity grants the request, it must (1) amend the patient's PHI, (2) inform the patient of the change and (3) notify others who may need to know of the change, such as other health care providers and Business Associates who have access to the patient's PHI.

If a Covered Entity denies the amendment request, it must give the patient a written denial that explains (1) the reason for the denial, (2) the patient's right to submit a statement disagreeing with the denial, (3) the patient's right to ask that the original amendment request and denial be attached to any future disclosures of his or her PHI, and (4) how to complain to the Covered Entity or the Department of Health and Human Services about the denial.

**Right #6: Patients must be given an accounting of the Covered Entity's disclosures of their protected health information.**

The privacy regulations also give patients the right to request and get an accounting; that is, a detailed listing of all disclosures of their PHI that the Covered Entity made during the six years before the date of the request. There are several exceptions to this patient right. The biggest is that the accounting doesn't have to include any disclosures that were made to carry out treatment, payment, and health care operations. For example, an accounting prepared by a hospital need not include a list of all disclosures that were made to billing department personnel for purposes of getting payment for the patient's hospital stay. But the accounting must list other disclosures made by the organization, including those made to or by its Business Associates, such as its accountants or its billing company. The accounting must include details of the disclosures, such as the date the disclosure was made, the name of the person or organization receiving the PHI, the recipient's address (if known), a short description of the PHI disclosed, and the reason for the disclosure. Generally, a Covered Entity must give the accounting to the patient within 60 days of the patient's request, but it may get a 30-day extension. The Covered Entity may not charge the patient for the first accounting in a 12-month period, but may charge a reasonable cost-based fee for additional requests made by the same patient in the same 12-month period.

**G. Administrative Requirements**

The Final Rule includes administrative requirements that essentially require Covered Entities to establish a framework to achieve organizational compliance. §§164.530. These

administrative requirements require Covered Entities to appoint privacy staff, implement policies and procedures and train employees.

**(1) Privacy Staff:** Covered Entities will be required to designate a privacy official to oversee compliance and a contact person to receive complaints and questions. §§ 64.530(a). Although HHS indicated that organizations would not necessarily need to create an entirely new position for these roles, many analysts are skeptical that a person assigned to other duties can adequately handle this cumbersome task, particularly in larger organizations.

**(2) Policies and Procedures:** Covered Entities will be required to develop and implement policies to establish compliance with the Final Rules. §§ 164.530(c)-(i). Specifically, Covered Entities must have policies to accomplish the following tasks: (1) protect the accidental or intentional misuse or disclosure of PHI; (2) establish a grievance procedure for violations of the organizations's privacy policies; (3) prevent retaliation for complaints or reports of noncompliance and address applying changes in privacy policies to PHI already collected; (4) impose sanctions against employees who violate the organization's privacy policies; (5) mitigate effects of errant disclosures by the entity or by a Business Associate; and (6) guarantee an individual's right to complain.

**(3) Training:** Covered Entities must also train employees on the organization's privacy policies and must re-train employees if material changes are made to such policies. §§ 64.530(b). The controversial provision of the proposed rule that required employees to sign a certification that they received training on the policies and recertify such document every three years has been eliminated in the Final Privacy Rule.

## **V. State Law Pre-Emption**

State privacy standards or requirements are pre-empted by the Final Privacy Rule if they are "contrary to" HIPAA's requirements. "Contrary to" means that (1) a Covered Entity would find it impossible to comply with both the State and federal requirements, or (2) the provision of State law stands as an obstacle to the accomplishment and execution of the full purposes of HIPAA. *See* 45 C.F.R. § 160.202. A "contrary" state law provision may still stand if it is an exception to federal preemption as set forth in the HIPAA privacy rule. *See* 45 C.F.R. § 160.203. These exceptions include: state laws related to health care fraud and abuse; regulation of health

plans; reporting on health care delivery or costs; public health, safety, or welfare; and the regulation of controlled substances. Under these exceptions, the federal rule will remain in effect until HHS has made a determination based on reviewing a request for an exception by the state governor (or his or her designee) as to whether the state law fits into the exception and will stay in effect.

The HIPAA privacy regulations can be pre-empted by State law. State privacy laws which are not "contrary to" HIPAA's requirements but instead are "more stringent" than HIPAA, "preempt" the Final Rule. State privacy laws are "more stringent" than HIPAA when they meet one or more of the following six criteria:

That is, the state law must:

1. Further prohibit or restrict the use or disclosure of individually identifiable health information (IIHI) than that prohibited or restricted by the HIPAA privacy rule.
2. Permit patients greater rights to access or greater ability to amend the individually identifiable health information (IIHI)
3. Permit patients greater rights to know who has used or disclosed IIHI, or more remedies with regard to use and disclosure.
4. Contain authorization or consent requirements that narrow the scope or duration, reduce the coercive effect or, in general, give IIHI more privacy protection than the federal HIPAA standards.
5. Provide for more record retention requirements or provides for a longer period to retain the records.
6. Expand or increase the types of health information that must be protected, for instance as it related to communicable diseases or genetic health information. 45 C.F.R. § 160.202.

Disputes about whether a state law is more stringent than the corresponding provision in the HIPAA privacy rule will not be decided by HHS, but must be ruled on by state courts.

**VI. Violations (or, why comply?)**

The Final Rule does not include a private cause of action, dropping a requirement in the proposed regulations that patients be designated as third-party beneficiaries of written privacy agreements between healthcare entities and their business associates. However, Violations of the rules may subject Covered Entities to criminal or civil penalties. *See* 42 U.S.C. §§1320d-5 and 1320d-6. HHS may impose civil penalties equal to \$100 per violation up to an annual maximum of \$25,000 for the violation of each provision of the rule. The rule indicates, however, that HHS will take a cooperative approach to civil enforcement, relying on informal dispute resolution and the provision of technical assistance. Criminal penalties may be imposed on a Covered Entity who knowingly and in violation of HIPAA uses or causes to be used a unique health identifier, or obtains or discloses individually-identifiable health information. The HIPAA statute authorizes imposition of a fine of up to \$50,000 and a jail sentence of up to one year for such a violation. If the offense is committed under false pretenses, the maximum penalty increases to a \$100,000 fine and five years imprisonment. If the offense is committed with the intent to sell, transfer, or use individually-identifiable health information for commercial advantage, personal gain or malicious harm, the maximum penalty is a \$250,000 fine and 10 years imprisonment.

The Department for Health and Human Services has delegated to the Office of Civil Rights its authority to enforce the HIPAA privacy regulations. The Office of Civil Rights now has the authority to impose civil monetary sanctions for non-compliance with the final HIPAA privacy regulations, determine when state laws aren't pre-empted by HIPAA, administer the privacy regulations, and make decisions on how to interpret, implement, and enforce the privacy regulations. The Office of Civil Rights' authority begins on the effective date of the final HIPAA privacy regulations, which, as noted earlier, is somewhat uncertain at this time.

## PART II. HIPAA AND FINANCIAL INSTITUTIONS

The extent to which banks are impacted by HIPAA will depend upon the answers to the following questions:

- a. When is a bank a "Healthcare Clearinghouse" under HIPAA? and,
- b. When is a bank a "Business Associate" under HIPAA?

These are not mutually exclusive findings as most Healthcare Clearinghouses are also Business Associates.<sup>5</sup>

### **A. When is a Bank a "Healthcare Clearinghouse" under HIPAA?**

#### *Background on Healthcare Clearinghouses*

Healthcare clearinghouses can have either healthcare providers or health plans or both as customers. Those serving providers often capture a print image of a paper claim form at the providers site, edit the claim data for errors or required codes, and reformat the claim to meet the unique data layout requirements of various health plans. Health plan-oriented clearinghouses provide claims receipt services for health plans, which may delegate the entire task of trading partner acquisition and testing to their clearinghouses for a fee. Clearinghouses can serve both the health plan and provider markets. This is the type of company that clearly was at the forefront of HHS's intent when the statute's definition of "Healthcare Clearinghouse" was drafted.

#### *Background on the Banking Industry's Automated Clearinghouse Network*

Banks commonly use the term "clearinghouse" to refer to a facility for the exchange of payment information. There are local and regional check clearinghouses in which paper checks are exchanged and settled in accordance with rules developed by the members. Perhaps better known and more important in this context is the Automated Clearing House ("ACH"), a network for the exchange of payment and related remittance information that operates under a uniform set of rules developed and administered by NACHA- (the Electronics Payments Association) on behalf of more

---

<sup>5</sup>The majority of this section of the materials is based on the "White Paper on HIPAA Related Issues Affecting the Banking Industry," a Working Paper prepared by the Banking Industry HIPAA Task Force, submitted for discussion to HHS May 29, 2002, revised July, 2003. It is also based, to a lesser extent, on a Memorandum prepared by Morrison & Foerster, LLP obtained by Ian Macoy of NACHA, March 19, 2003. Both documents are attached for review.

than 12,000 financial institutions and the Federal Reserve. Despite the similarities in their names, the business function of the ACH is completely distinct of a Healthcare Clearinghouse. An ACH does not itself take responsibility for any data conversion. The processing of payment files by NACHA member banks is more focused on routing standard files to effect payment rather than transforming or reformatting files as a service. The routine processing of NACHA files by member banks may require some editing to ensure that the message is routed correctly. But these routine payment functions are clearly different (and substantially less expensive) than the services provided by Healthcare Clearinghouses.

NACHA, the American Bankers Association (“ABA”) and the HIPAA Banking Industry Task Force believe that no bank is a clearinghouse under HIPAA by mere origination or receipt of an ACH transaction for relevant HIPAA standard transactions (premium and claim payments). Although banks may originate or receive HIPAA standard transactions such as the Healthcare Claim Payment (835) and Premium Payment (820), they will often pass the related remittance data without any responsibility for conversion or reformatting of the X12 message contained in the NACHA CTX “envelope”. Although the messages might be HIPAA standard transactions, the bank may provide only transport and payment functions. These are the customary services purchased from banks and many industries including healthcare.

#### *Background on Additional Banking Services*

A small number of banks may provide additional services for their healthcare customers. Some health plans and providers may pay banks to provide additional support services by translating or editing files to meet the criteria specified in the *HIPAA Implementation Guidelines*. Banks will be clearinghouses when they choose to provide services that translate files from non-standard to HIPAA-compliant standard formats as requested by customers. Other banks provide “lockbox” services where the bank picks up checks and remittance advices directly from the postal service, deposits the checks and performs some scanning, photocopying and key entry of remittance data. This information may be transmitted electronically in a variety of formats to the customer but this data capture service is not a clearinghouse operation because there is no conversion from an incoming electronic format.



Lockbox services have raised the possibility that Banks performing such services could be deemed Business Associates under HIPAA. HHS has yet to officially comment directly on this issue. However, attached to these materials is a Memorandum from Kilpatrick Stockton LLP requested by the Kentucky Bankers Association regarding this issue (the "Memorandum"). The Memorandum comes to the conclusion that a Bank can reasonably proceed under the position that the Bank is conducting an activity that directly facilitates or effects the transfer of funds for compensation for health care. The HIPAA Preamble indicates that a Bank will not be acting on behalf of a physician when it "... conducts any other activity that directly facilitates or effects the transfer of funds for compensation for health care." The Memorandum also states that while Banks also receives PHI (such as EOBs and invoices) along with a payment transaction under lockbox transactions, if the Bank does not need or use this information in performing its services and it simply forwards this information to the physician without any use or disclosure of the PHI, it is reasonable to assume the bank is not a Business Associate under HIPAA. We offer no opinion as to the accuracy of legal analysis of the Memorandum. It is simply attached for informational purposes.

The HIPAA rules generally permit the disclosure of PHI by a covered entity for payment purposes without the need for authorization by the individual. The definition of "payment" in the HIPAA rules is broad and includes, *inter alia*, the activities undertaken by a health plan to provide reimbursement for the provision of healthcare. The supplementary information to the final HIPAA rule notes that:

Covered entities may disclose protected health information for payment purposes to any other entity, regardless of whether it is a covered entity. For example, a healthcare provider may disclose protected health information to a financial institution in order to cash a check or to a Healthcare Clearinghouse to initiate electronic transactions. 65 Fed. Reg. 82,462, 82,495 (Dec. 28, 2000)

The amount of information in this disclosure by a covered entity is subject to a "minimum necessary standard." Despite this limitation, in the supplementary information accompanying the HIPAA rules, HHS states that the transmission of both electronic funds transfer ("EFT") information and electronic remittance advice ("ERA") information are payment activities. 65 Fed. Reg. 82,462, 82,615, 82,616 (Dec. 28, 2000)

Most payment services provided by banks do not classify a bank as a Healthcare Clearinghouse regulated by HIPAA. There is, in fact, a specific exclusion in the regulation for payment activities.

Section 1179 of the HIPAA statute itself provides that:

To the extent that an entity is engaged in activities of a financial institution (as defined in Section 1101 of the Right to Financial Privacy Act of 1978) or is engaged in authorizing, processing, clearing, settling, billing, transferring, reconciling, or collecting payments, for a financial institution, this part, and any standard adopted under this part, shall not apply to the entity with respect to such activities, including the following:

- (1) "The use or disclosure of information by the entity for authorizing, processing, clearing, settling, billing, transferring, reconciling or collecting, a payment for, or related to, health plan premiums or healthcare, where such payment is made by any means, including a credit, debit or other payment card, an account, check, or electronic funds transfer..."

Although the HIPAA rules do not provide an express exclusion from the definition of "Healthcare Clearinghouse" for financial institutions, a statement in the supplementary information accompanying the HIPAA rules indicates that HHS recognizes this exclusion, at least for payment purposes. In discussing the definition of a "Business Associate" in Section 160.103 of the HIPAA rules, HHS stated in the supplementary information that:

We do not consider a financial institution to be acting on behalf of a covered entity, and therefore no Business Associate contract is required, when it processes consumer-conducted financial transactions by debit, credit, or other payment card, clears checks, initiates or processes electronic funds transfers, or conducts any other activity that directly facilitates or effects the transfer of funds for compensation for healthcare. 65 Fed. Reg. 82,462, 82,476 (Dec. 28, 2000)

Under the definitions of "Protected Health Information" and "Healthcare Clearinghouse" a Receiving Depository Financial Institution ("RDFI") engaged in ACH payment activity could be construed to be a Healthcare Clearinghouse. For example, an RDFI might receive a credit ACH

entry for a receiver who is a doctor or other healthcare provider sent by a patient's health insurer. The entry could include information from both the EFT and ERA component of the ASC X12N 835 standard, thereby identifying the patient and the treatment for which the payment is being made. This information is PHI within the meaning of the HIPAA rules. By receiving ERA information in a HIPAA standard format and converting the ERA information to the non-standard format in which the doctor or healthcare provider ordinarily receives information about ACH entries, the RDFI could be interpreted to be performing the functions of a Healthcare Clearinghouse within the definition of that term in the HIPAA rules.

However, a reading of the HIPAA rules in their entirety strongly weighs against this interpretation. The structure of the HIPAA rules is to regulate covered entities and the information they disclose to outside entities. It would be contrary to this structure to believe that HHS intended a financial institution to become a covered entity simply by processing payments delivered to the financial institution, directly or indirectly, by a covered entity. In addition, for HHS to regulate financial institutions due to their participation in payment activities would be contrary to Section 1179. For instance, an Originating Depository Financial Institution ("ODFI") may receive information for payment purposes from a covered entity, and an RDFI may receive information for payment purposes from an ODFI. These organizations are entitled to assume that the covered entity is complying with the HIPAA rules with respect to that information. The mere act of receiving and processing information as described above, even where such information includes PHI would not seem to transform the ODFI or the RDFI into a covered entity in the form of a Healthcare Clearinghouse.

This view is consistent with the statutory language in HIPAA creating the detailed Section 1179 exclusion for payment purposes. The view is confirmed by statements by HHS in the supplementary information to the HIPAA rules. There is no evidence that HHS intended to include financial institutions that would ordinarily enjoy the Section 1179 exclusion within the definition of a "Healthcare Clearinghouse" simply because they engage in ACH payment activity. For example, HHS does not purport to interpret Section 1179 in defining Healthcare Clearinghouse to limit the types of payment activities that can be performed by financial institutions. To the contrary, HHS itself states that payment activity as defined in the HIPAA Privacy Rule includes the transmission of both the EFT and the ERA components of the ASC X12N 835 standard. Further, as noted above, HHS expressly recognizes that contracts are not required when a financial institution

processes electronic funds transfers or conducts any other activity that directly facilitates or effects the transfer of funds for compensation for healthcare.

Therefore, it would appear that under the HIPAA rules, a financial institution engaged in ACH payment activity should not be considered a Healthcare Clearinghouse and therefore should not be subject to HIPAA. However, this is far from clear. There has been much debate on this subject matter. Certain activities performed by banks, specifically, certain value - added translation services, either bundled with or separate from ACH services, may qualify the bank as a "HIPAA Healthcare Clearinghouse". Therefore, the Banking Industry HIPAA Task Force has developed a specific test to determine when banks are or are not considered Healthcare Clearinghouses under HIPAA. These proposed guidelines for bank clearinghouse status determination allow banks to determine under what circumstances they are required to be HIPAA compliant as a Healthcare Clearinghouse and will indicate what services are "specific value - added" and "clearinghouse - activities" contrasted with routine payment processing exempted under Section 1179. The purpose of the proposed guidelines for bank Healthcare Clearinghouse status determination is to provide a clearer presentation of the banking industry's position on its Healthcare Clearinghouse status under HIPAA.

A specific test must be applied to determine if a bank is or is not a Healthcare Clearinghouse. The test is based on services provided and should be documented by contractual agreements with banks and their customers. The test question for a bank to be classified as a Healthcare Clearinghouse or not is: "Is the bank editing or reformatting data against the specifications of the *HIPAA Implementation Guidelines*?" If the answer is "YES", then the bank is a Healthcare Clearinghouse. Other edits or reformatting tasks performed against financial institutions by X12 and NACHA requirements are part of routine payment processing and are exempt under Section 1179 of the HIPAA statute. Today most contracts between banks and their customers do not have language that specifies whether the bank is defined as a Healthcare Clearinghouse. The HIPAA Banking Industry Task Force recommends that contracts between banks and their customers have standard clauses that clearly state that the bank **is or is not** a Healthcare Clearinghouse under HIPAA. According to the Banking Industry HIPAA Task Force, the test question can be applied to many different scenarios and allow for a clear delineation between routine payment processing and Healthcare Clearinghouse services.

#### **The Bank Is A Healthcare Clearinghouse**

1. ODFI's that contract with "covered entity" customers to convert any of the HIPAA mandated transactions in proprietary data formats to HIPAA - compliant standard formats are Clearinghouses under the HIPAA regulations if the following condition applies:

- a) The bank is editing or reformatting files for its customers using the *HIPAA Implementation Guidelines* as the source of edits.

2. RDFI's that contract with "covered entity" customers to convert HIPAA - compliant standard transactions received to non-HIPAA - compliant formats required by the customer are Healthcare Clearinghouses if the following condition applies:

- a) The bank is editing or reformatting files for its customers using the *HIPAA Implementation Guidelines* as the source of edits.

The Banking Industry HIPAA Task Force has developed Healthcare Clearinghouse determination test cases that are appropriate to illustrate application of the above test question and present typical payment processing routines and value added services that would classify the bank as a Healthcare Clearinghouse and a covered entity under HIPAA. The cases are presented in two groups based on services for either outgoing (ODFI) or incoming (RDFI) payments.

#### **Originating Depository Financial Institution**

##### **CASE 1**

- A health plan sends a proprietary flat file with healthcare claim payments and the ODFI reformats the data into the X12 835 standard and further manipulates the data to create a properly formatted CTX (NACHA format). The properly formatted NACHA file is then submitted to the ACH network for processing. The bank has contracted with its customer to provide a HIPAA compliant transaction as determined by the *HIPAA Implementation Guidelines*. Reformatting was proprietary to X12 and to NACHA.

**Determination:** The bank is a Healthcare Clearinghouse because it is reformatting and editing the data against the requirement of the *HIPAA Implementation Guidelines*.

#### **Receiving Depository Financial Institution**

##### **CASE 2**

- An RDFI receives multiple NACHA files via the ACH network. The CTX files are bound for the same provider payee. The RDFI merges the properly formatted CTX

files into a consolidated file to send to the intended provider. The RDFI also received 835 files from value added networks that are to be reassociated with payment data sent separately. The resulting, merged transactions are then sent to a receiver in an 835 format. The provider has asked the bank to edit the incoming 835 files against the *HIPAA Implementation Guidelines* and to manage the receipt or rejection processing of the 835 data in addition to performing payment processing services.

**Determination:** The bank is a Healthcare Clearinghouse because it is formatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

### **The Bank Is Not A Healthcare Clearinghouse**

The Banking Industry has been providing payment processing services for decades and has significant regulations and responsibilities for standards - based payment processing. Banks provide occasional file editing and reformatting functionalities in the routine course of payment processing. If the customer does not want to require its bank to perform *HIPAA Implementation Guidelines* compliance checking against incoming or outgoing payment files it would be inappropriate to classify the bank as a Healthcare Clearinghouse for its completion of routine payment services provided to customers in all industries. This seems to be in line with the Section 1179 exclusion found in the HIPAA statute.

### **Originating Depository Financial Institution**

1. ODFI's whose customers ask them to originate payments with Banking Industry standard editing and reformatting functionalities **are not** Healthcare Clearinghouses under HIPAA. These banks are contractually obligated to effect payment and remove remittance data and are not contractually responsible for editing or formatting payment data against the *HIPAA Implementation Guidelines*.

- a.) ODFI's can accept NACHA files from customers with or without HIPAA compliance remittance data enclosed, without being defined as a Healthcare Clearinghouse.

- b) Reformatting from X12 to NACHA or from a proprietary format to NACHA for payment processing does not constitute Healthcare Clearinghouse activity.
- c) Editing and supplementing payment data for completeness against X12 and NACHA standards alone does not constitute Healthcare Clearinghouse activity.

### **Receiving Depository Financial Institution**

1. RDFI's that merely receive payments in any NACHA format and route any data to customers based on a variety of routing instructions **are not** Healthcare Clearinghouses under HIPAA.

- a.) RDFI's can accept NACHA files, with or without HIPAA - compliance remittance data enclosed, without being a Healthcare Clearinghouse.
- b) Reformatting from NACHA files to X12, BAI or proprietary formats and routing of remittance data does not constitute Healthcare Clearinghouse activity.
- c) Editing and supplementing data for completeness against X12 and NACHA standards alone does not constitute Healthcare Clearinghouse activity.

The following test cases illustrate typical payment processing routines that **would not** classify the bank as a Healthcare Clearinghouse and a covered entity under HIPAA. The cases are presented in two groups based on services for either outgoing (ODFI) or incoming (RDFI) payments.

### **Originating Depository Financial Institution**

#### **CASE 3**

- A health plan sends a properly formatted CTX (NACHA format) to its ODFI containing a healthcare claim payment/advice (835) transaction, and the ODFI submits the transaction to the ACH network. Edits applied were NACHA. No reformatting was involved.

**Determination:** The bank **is not** a Healthcare Clearinghouse because it **is not** reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

#### **CASE 4**

- A health plan sends a properly formatted healthcare claim payment/advice (835) transaction to the ODFI, and the ODFI places the properly formatted 835 into the CTX (NACHA format) and submits the transaction to the ACH network. Edits applied were X12. Reformatting was X12 to NACHA.

**Determination:** Bank is **not** a Healthcare Clearinghouse because it is **not** reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

### **Receiving Depository Financial Institution**

#### **CASE 5**

- An RDFI receives a properly formatted CTX (NACHA format) via the ACH network. That NACHA file is then passed on to the provider receiver (payee). Edits applied were NACHA. No reformatting was done.

**Determination:** Bank is **not** a Healthcare Clearinghouse because it is **not** formatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

#### **CASE 6**

- An RDFI receives a properly formatted CTX (NACHA format) via the ACH network and extracts the 820 or 835 from the CTX files. That 820 or 835 is then passed onto the provider receiver (payee). Edits applied were NACHA and X12. Reformatting was NACHA to X12.

**Determination:** Bank is **not** a Healthcare Clearinghouse because it is **not** reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

#### **CASE 7**

- An RDFI receives a properly formatted CTX (NACHA format) via the ACH network. Pertinent data in the CTX file is then passed onto the provider receiver (payee) via human readable methodology. Human readable methodology includes, but is not limited to, fax, e-mail, printed advice, bank statement, information reporting terminal or software. The reformatting is NACHA to X12 to human readable. Edits applied were NACHA and X12.

**Determination:** Bank is **not** a Healthcare Clearinghouse because it is **not** reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

Financial institutions are required by ACH network rules promulgated by NACHA to forward payment related information to receivers upon request. This is, therefore, a normal (and required)



function of the payment network. Banks and their customers must establish HIPAA - compliant secure communications for the dissemination of this human readable information.

#### **CASE 8**

- Paper healthcare claim payment data in the form of explanation of benefits/remittance advice statements sent from a health plan to a provider are keyed in a lock box processing area within the bank and sent electronically in a BAI or X12 format to the provider receiver (payee). Images of the items received in the lock box are also sent to the payee, or otherwise made available upon request. No edits. No reformatting.

**Determination:** Bank is **not** a Healthcare Clearinghouse because it is **not** reformatting and editing against the requirements of the *HIPAA Implementation Guidelines*.

#### **CASE 9**

- An RDFI receives a properly formatted CTX (NACHA format) via the ACH network. Paper transactions keyed in at lock box processing operations at the bank are then merged with 820 or 835 data. The resulting 820 or 835 is then transmitted to the receiver (payee). The reformatting is NACHA to X12. Edits applied were NACHA or X12 to CTX transmission.

**Determination:** Bank is **not** a Healthcare Clearinghouse because it is **not** reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

Financial institutions, as a normal course of business, receive payments via various methodologies (ACH, wire, check, et al) and must report on these payments in a manner consistent with the capabilities of the receiver's (payees) account receivable systems. Banks routinely merge data files and forward a "consolidated" file to the receiver to streamline and simplify the reconciliation process. The customer in this example is not requesting the bank to edit or reformat incoming data against *HIPAA Implementation Guidelines*.

#### **CASE 10**

- An RDFI receives a NACHA reformatted file (CCD or CCD +) via the ACH network. The RDFI receives an 820 or an 835 from an external network or third-party healthcare provider for reassociation purposes. The resulting, reassociated transactions are then sent to the receiver (payee) in an 820 or 835 format. The reformatting was NACHA to X12. Edits applied were NACHA or X12.

**Determination:** Bank is **not** a Healthcare Clearinghouse because it is **not** reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

Financial institutions, as a normal course of business, receive payment and payment related information from multiple sources. Banks routinely reassociate payments received from the ACH network with payment related information received from the third-party network or service provider and merge the data files for reconciliation purposes. This merged file is then sent to the receiver. The customer in this example is not paying for the bank to edit or supplement incoming data against the *HIPAA Implementation Guidelines*.

It is important to keep in mind that the above discussed test cases are based upon tests formulated by the HIPAA Banking Industry Task Force. While they are helpful guidelines for banks to determine when they may or may not qualify as a Healthcare Clearinghouse for the purposes of HIPAA, they are not necessarily conclusive in this regard. These tests have not been formally adopted by the Office of Civil Rights or the Centers for Medicare and Medicaid Services as carrying any weight under HIPAA law. The debates regarding whether or not banks are or are not subject to HIPAA, and in what capacity they are subject to HIPAA remains a very fluid concept. The Office of the Comptroller of the Currency has determined that based on Section 1179 of the statute, banks are 100% exempt from HIPAA. In contrast, the framers of the statute argue that this exemption was exclusively granted to permit consumer-conducted financial transactions, (i.e. credit cards, personal checks, etc.), allowing the consumer to decide when to use a card or check that would link them with sensitive treatments.

Many experts agree that the exemption does not cover PHI (i.e. claims remittance information) that accompanies health plan payments through the banking system. In the meantime, a national clearinghouse association drafted a letter to HHS Secretary Thompson objecting to special treatment for banks under HIPAA. At the Medical Banking Project's "The Great American Interoperability Tour," the Centers for Medicare and Medicaid Services publically acknowledged that they were considering completely exempting banks from HIPAA. The National Committee on Vital and Health Statistics will be hearing testimony in February and March of 2004 relating to these issues. Thus, it is clear that many of the issues discussed in this section are still being worked out.

## **B. When is a Bank a "Business Associate" under HIPAA?**

### *Background on Business Associates*

The Banking Industry HIPAA Task Force identified a need to clarify the application of the Business Associate relationship to banking services. It is recognized that banks may be deemed "Business Associates" of HIPAA covered entities such as health plans and providers when the banks process payment transactions/remittance data containing PHI. Health plan and provider customers will, therefore, seek to revise existing bank contracts to incorporate applicable HIPAA privacy and security requirements for banks as Business Associates. To assist the industry, the Banking Industry HIPAA Task Force has developed, with the assistance of several institution attorneys, a Banking Industry version of Model Business Associate Contract provisions available at [www.hipaabanking.org/bus\\_content.html](http://www.hipaabanking.org/bus_content.html)

### **Proposed Guidelines for Business Associate Status Determination**

The purpose of the proposed guidelines for bank Business Associate status determination is to provide a clear presentation of the banking industry's position on its business associate status under HIPAA. Test questions must be answered to determine if a bank is or is not a Business Associate. The test questions for Business Associate determination will be the following:

"Does the bank have access to PHI? Does its customer have a contractual agreement that defines the bank as a Business Associate?" If the answer is "YES" to both these questions then the bank is a Business Associate. Today most contracts between banks and their customers do not have language that specifies whether the bank is defined as a Business Associate. It is recommended that contracts between banks and their customers have standard clauses that clearly state that the bank is or is not a Business Associate under HIPAA. It is the responsibility of the covered entity to negotiate a Business Associate contract with its bank.

### **The Bank is a Business Associate**

The following Business Associate determination test cases are appropriate to illustrate application of the above test questions and present typical banking services and contractual relationships that would classify the bank as a Business Associate under HIPAA.

#### **CASE 11**

- A health plan sends a proprietary flat file with healthcare claim payments and the ODFI formats the data into the X12 835 standard and further manipulates the data to create a properly formatted CTX (NACHA format). The properly formatted NACHA

file is then submitted to the ACH network for processing. The bank has contracted with its customer to provide a HIPAA complaint transaction as determined by the *HIPAA Implementation Guidelines*. The contract between the bank and its customer indicates that the bank is a Business Associate. The bank has access to because of the PHI contained in the 835 HIPAA standard transaction sent by the health plan to the bank.

**Determination:** The bank is a Business Associate because the answers to the test questions are positive. The contract between the bank and its customer does specify that the bank is a Business Associate, and the bank does have access to PHI. As mentioned earlier, clearinghouses are also business associates and in this example the bank is both a Clearinghouse and a Business Associate. Case 11 and Case 1 are the same in order to clearly illustrate that a Clearinghouse can be a Business Associate.

#### **CASE 12**

- An RDFI receives multiple NACHA files via the ACH network. These CTX files are bound for the same provider payee. The RDFI merges the properly formatted CTX files into a consolidated file to send to the customer. The RDFI also receives 835 files from value added networks that are to be reassociated with payment data sent separately. The resulting, merged transactions are then sent to the receiver in an 835 format. The customer has asked the bank to edit the incoming 835 files against the *HIPAA Implementation Guidelines* and to manage the receipt or rejection processing of the 835 data in addition to performing payment - processing services. The contract between the bank and its customer identifies that the bank is a Business Associate when the bank has access to PHI through the data contained in the 835 HIPAA standard transaction.

**Determination:** The bank is a Business Associate because the answers to the test questions are positive. The contract between the bank and its customer does specify that the bank is a Business Associate. As mentioned earlier, Clearinghouses are also Business Associates and in this example the bank is both a Clearinghouse and a Business Associate. Case 12 and Case 2 are the same in order to clearly illustrate that a Clearinghouse can be a Business Associate.

#### **CASE 13**

- A health plan sends a properly formatted CTX (NACHA format) containing a healthcare claim payment/advice (835) transaction and the ODFI passes on the received NACHA file to the ACH network. The contract between the bank and its customer indicates that the bank is a Business Associate. The bank has access to PHI because of the PHI contained in the 835 HIPAA standard transaction sent by the health plan to the bank.

**Determination:** The bank is a Business Associate because the answers to the test questions are positive. The contract between the bank and its customers does specify that the bank is a Business Associate. The bank has access to PHI. Unlike the two prior examples the bank is not a Healthcare Clearinghouse because data translation and validation against the *HIPAA Implementation Guide* have not occurred. Case 13 and Case 3 are the same in order to clearly illustrate a circumstance where the bank is not a Clearinghouse and is a Business Associate.

#### **CASE 14**

- Paper healthcare claim payment data in the form of explanation of benefits/remittance advice statements sent from a health plan to a provider are keyed in a lockbox processing area with the bank and sent electronically in a BAI or X12 format to the provider receiver (payee). Images of the items received in the lock box are also sent to the payee. The contract between the bank and its customer indicates that the bank is a Business Associate. The bank has access to PHI because of the PHI contained in the 835 HIPAA standard transaction and PHI contained in paper explanation of benefits/remittance advice statements.

**Determination:** The bank is a Business Associate because the answers to the test questions are positive. The contract between the bank and its customers does specify that the bank is a Business Associate. The bank has access to PHI. In this example the bank is not a Healthcare Clearinghouse because data translation and validation against the *HIPAA Implementation Guide* have not occurred. Case 14 and Case 8 are the same in order to illustrate a circumstance where the bank is not a Clearinghouse and is a Business Associate.

#### **The Bank is not a Business Associate**

The following Business Associate determination test case is appropriate to illustrate application of the test question and present typical banking services that would not classify the bank as a Business Associate under HIPAA.

**CASE 15**

- A health plan uses a bank for a variety of services specifically:
  - Trust, safekeeping and custody of investment securities
  - Investment services (advice and trade executions)
  - Payroll processing

The contract between the bank and the customer indicates that the bank is not a Business Associate. The bank has no access to PHI.

**Determination:** The bank is **not** a Business Associate because the answers to the test questions are negative. The contract between the bank and its customers does not specify that the bank is a Business Associate. The bank has no access to PHI.

Again, it is important to note that the tests discussed above for determining whether a bank is a Business Associate have been determined by the Banking Industry HIPAA Task Force. These guidelines are helpful for banks to determine when they may or may not be Business Associates under the HIPAA rules. However, they have not been excepted as definitive tests by the Office of Civil Rights or the Centers for Medicare and Medicaid Services, the agencies responsible for enforcing and administering the HIPAA rules. One important thing to note under these Business Associate tests outlined above relates to the absence of a contract stating that a bank is or is not a Business Associate. This is certainly not definitive of whether or not one is or is not a Business Associate. There could be many circumstances in which a bank does not have a contract that delineates it is a Business Associate when, in fact, it is operating as a Business Associate for the purposes of HIPAA. It is true that banks and its customers should definitely explore providing specific Business Associate language in its contract where appropriate.

However, the absence of such language does not mean one is not a Business Associate. One argument used to support this theory is it is the covered entity who is responsible for insuring its Business Associates are disclosed and delineated under contract. Therefore, presumably, a Business Associate cannot be punished under HIPAA for operating as a Business Associate without having a contract that states one is Business Associate. This should be the covered entity's responsibility and presumably it would be the covered entity that would suffer any enforcement actions under

HIPAA. However, HIPAA enforcement is relatively new and should be viewed cautiously. Additionally, covered entities may have indemnity provisions which make this lack of punishment argument moot. So, while helpful, these tests are simply guidelines. They are not to be used as definitive determinations of whether a bank has or has not complied with HIPAA rules and regulations. Another helpful tool that is attached to these materials is a document entitled *Financial Institutions Acting as Business Associates: Self Assessment Checklist for HIPAA Privacy for Health Care Customers*.

## CONCLUSION

As noted above, banks may or may not be considered Healthcare Clearinghouses under HIPAA depending on the types of activities in which they engage. There has been much discussion regarding Section 1179 of the HIPAA statute as to whether this fully exempts banks from HIPAA. As noted above, this is still being considered by HHS. The National Committee on Vital and Health Statistics is hearing testimony all this month relating to these issues. The primary issue being discussed in this testimony is whether or not banks should be completely exempted from HIPAA. As it stands currently, banks are not completely exempt from HIPAA. Several respected experts have determined that banks engaged in payment processing as defined by HIPAA are not considered covered entities under the regulation. However, financial institutions engaged in activities that fall outside the boundaries of payment processing as defined by HIPAA may still be considered covered entities. This generally relates to any type of value added services that are performed on behalf of bank's customers. The Banking Industry HIPAA Task Force has developed many of the guidelines discussed above that can be used to help banks determine the appropriate classification of your organization under the HIPAA regulations. But, it is extremely important to note that at the time of this writing all of the guidelines that have been adapted by the Banking Industry HIPAA Task Force have not been addressed by HHS. Therefore, they are simply guidance and carry no legal weight in regards to HIPAA at this time. As noted, that may change based on some of the testimony being heard currently. Consequently, as it stands currently, a bank must thoroughly review the HIPAA statutes and regulations to determine whether or not, based on their activities, they could be considered a Healthcare Clearinghouse (covered entity) or a Business Associates under HIPAA.



# **WHITE PAPER ON HIPAA RELATED ISSUES AFFECTING THE BANKING INDUSTRY**

**A Working Paper**

**Prepared by the  
Banking Industry HIPAA Task Force**

**A Banking Industry Initiative Under the Auspices of  
NACHA -- The Electronic Payments Association  
and the American Bankers Association**

**Submitted for Discussion to DHHS**

**May 29, 2002**

**Revised July, 2003**





## Table of Contents

I.	Introduction.....	2
II.	Key Issues .....	4
III.	Key Concepts .....	5
	A. Covered Entities .....	5
	B. Standard Transactions, Privacy and Security Requirements.....	6
IV.	Banking Industry Issues under HIPAA.....	7
	A. When is a Bank a "Healthcare Clearinghouse" under HIPAA?.....	8
	Introduction.....	8
	Background on Healthcare Clearinghouses .....	8
	Background on the Banking Industry's Automated Clearinghouse Network.....	8
	Background on Additional Banking Services .....	9
	Proposed Guidelines for Bank Healthcare Clearinghouse Status Determination....	10
	Basic Tests	
	• The Bank Is a Healthcare Clearinghouse.....	10
	Test Cases	
	• The Bank Is Not a Healthcare Clearinghouse.....	12
	Test Cases	
	B. When is a Bank a "Business Associate" under HIPAA? .....	18
	Background on Business Associates.....	18
	Background on the HIPAA Privacy Rule .....	18
	Proposed Guidelines for Bank Business Associate Status Determination.....	18
	Basic Test	
	• The Bank Is a Business Associate.....	19
	Test Cases	
	• The Bank Is Not a Business Associate.....	22
	Test Cases	
	Background on the NACHA/ABA Banking Industry HIPAA Task Force.....	24



## **I. Introduction**

The banking industry, as represented by NACHA-The Electronic Payments Association, and the American Bankers Association ("ABA"), supports the goals of the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") to standardize and automate the processing of health insurance transactions. The banking industry also supports the goals of HIPAA to establish privacy and security standards that safeguard the confidentiality of protected health information.

In an effort to reduce healthcare costs, HIPAA requires healthcare providers and health plans to adopt standards for electronic administrative and financial transactions. Use of these standards could generate billions of dollars in savings for both the government and the private-sector healthcare industry. The banking industry stands ready to assist the healthcare industry in meeting this public policy goal by providing Automated Clearing House ("ACH") electronic payment and remittance data processing and services. The ACH Network is a secure, reliable and cost-effective method of moving both money and data together through the banking system. The ACH Network serves more than 12,000 financial institutions, 3.5 million businesses, and 100 million individuals. The ACH Network is used by the Federal Government for all electronic Social Security and vendor payments and by millions of businesses and individuals for direct deposit of payroll and corporate trade payments. In 2002 the ACH Network processed nearly 9 billion payments of which more than 160 million were business-to-business payments accompanied by over 500 million lines of remittance information in standard formats.

Financial institutions have been processing a large and growing number of financial electronic data interchange ("FEDI") transactions for years, including healthcare payments and related addenda. Moreover, the banking industry's unique capability to keep "dollars and data together" – i.e., payment-related information flowing as addenda with the payment entry itself through the ACH Network – is more efficient than routing the payment through a separate pipeline from the associated information. This approach is therefore wholly consistent with HIPAA's objective to reduce costs and simplify administration.

The banking industry has always operated under extensive Federal regulatory oversight and the ACH Network is governed by rules promulgated by the private sector and adopted by the Federal Government (e.g., 31CFR210). In addition, the Federal Reserve ACH Operating Circular recognizes the NACHA Operating Rules for ACH Payments originated by the Federal Reserve Banks, including all ACH payments initiated by Federal Government agencies.

The banking industry also has a long history of having the strongest protections against unauthorized access to customer information. In 1997, the banking industry announced a set of



privacy principles that emphasized the need for financial institutions to maintain appropriate security standards and procedures regarding unauthorized access to customer information.

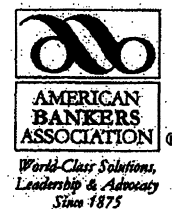
Financial institutions currently receive detailed guidance from federal and state banking regulators concerning information technology procedures and are regularly examined in this area by the regulators. In addition, financial institutions have in place today security policies and procedures developed on a bank-by-bank basis, factoring in the size and structure of each institution.

More importantly, under the Gramm-Leach-Bliley ("GLB") Act and its implementing regulations, financial institutions are obliged to protect non-public personal information and this is robustly enforced by banking regulators. GLB included a section that requires the banking agencies to establish appropriate standards relating to administrative, technical, and physical safeguards for customer records and information. This was codified as Regulation P in 12 CFR 216 on June 1, 2000. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation (the "banking agencies") have each adopted Interagency Guidelines for examining financial institutions in this area. These agencies regularly examine financial institutions for compliance with all applicable rules and regulations. Interagency guidelines establishing standards for safeguarding customer information were issued on February 1, 2001.

In order to enable the banking industry to fully understand the HIPAA regulations, NACHA and the ABA created the Banking Industry HIPAA Task Force to review the Act and its regulations. This White Paper represents the work of NACHA, the ABA and the Banking Industry HIPAA Task Force. Its purpose is to provide guidance for the banking industry and its customers in the healthcare industry on the impact of HIPAA requirements on the banking industry. NACHA, the ABA and the Banking Industry HIPAA Task Force further resolve to:

- Work with the Department of Health and Human Services to resolve questions of interpretation,
- Conduct an education campaign to inform the banking industry about the HIPAA legislation and its applicability to banks, including the security of protected health information,
- Develop tools for banks to monitor and measure compliance,
- Review banking industry standards and rules with regard to HIPAA provisions on an ongoing basis.

Readers are asked to direct their browsers to [www.hipaabanking.org](http://www.hipaabanking.org) for additional information on the activities of the Banking Industry HIPAA Task Force and updates on HIPAA.



## II. Key Issues

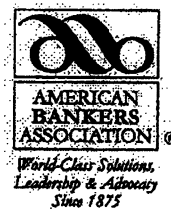
The Healthcare Insurance Portability and Accountability Act of 1996 is legislation that specifically regulates "covered entities" in the healthcare industry by setting requirements for standard transactions, privacy and security. Covered entities in turn are mandated by HIPAA to require their vendors who qualify as "Business Associates" to meet certain performance requirements. There are two key questions relating to the impact of HIPAA on the banking industry addressed by the Banking Industry HIPAA Task Force.

- 1) Are banks considered Healthcare Clearinghouses and thus covered entities?
- 2) Are banks considered Business Associates of health plans and providers?

NACHA and the ABA created the Banking Industry HIPAA Task Force ("Task Force") and engaged knowledgeable industry participants to address these and other related questions. Conference calls and meetings led the Task Force to a consensus on these issues. The Task Force produced this White Paper to set forth guidelines for banks and their customers to resolve issues of HIPAA compliance.

- The Task Force determined that :
  - The majority of banks are *not* Healthcare Clearinghouses and *not* covered entities under HIPAA as a result of their payment processing services.
  - A small number of banks are Healthcare Clearinghouses and are covered entities under HIPAA as a result of services provided in addition to their payment processing services.
  - HIPAA-related Banking Industry Guidelines would assist all banks and their customers to readily determine covered entity status based upon tests and model contract language developed by the Task Force.
- The Task Force also determined that:
  - Banks providing services to the healthcare industry may often be "Business Associates" of health plans and providers.
  - Banks have a long tradition of protecting confidential financial information and have security practices that meet or exceed many HIPAA requirements.
  - HIPAA-related Banking Industry Guidelines could assist all banks and their customers to adapt existing service contracts with model contract language developed by the Task Force.

For those readers who are not familiar with HIPAA, a highlight of the key concepts is presented below.



### III. Key Concepts

#### A. Covered Entities

HIPAA defines three classes of "**covered entity**" organizations subject to its regulations: health plans, healthcare providers, and Healthcare Clearinghouses.

- 1) "**Health Plans**" are broadly defined and include all health insurers, government payers (such as Medicare), private sector group plan arrangements such as HMOs and PPOs, employer group plans, and union benefit and welfare plans.
- 2) "**Healthcare Providers**" broadly include hospitals, physicians and physician groups, pharmacists and other suppliers of medical goods and services if they conduct transactions defined as standard transactions under HIPAA.<sup>1</sup>
- 3) "**Healthcare Clearinghouses**" are defined in the statute and regulations as any public or private entity that either:

"(1) Processes or facilitates the processing of information received from another entity in a nonstandard format or containing nonstandard data into standard data elements or a standard transaction [or]

(2) Receives a standard transaction from another entity and processes or facilitates the processing of information into nonstandard format or nonstandard data content for a receiving entity."<sup>2</sup>

#### **Comment:**

*It is the understanding of the Task Force that the regulation's definition of "Healthcare Clearinghouse" was written specifically to cover value-added data service companies in the healthcare industry commonly called "clearinghouses", but may also include other companies that offer similar services. The application of the definition to payment processing activities will be clarified in Section IV A, "When is a Bank a 'Healthcare Clearinghouse' under HIPAA?"*

---

<sup>1</sup> Covered entity means... A health care provider who transmits any health information in electronic form in connection with a transaction covered by this subchapter. " [Federal Register: August 17, 2000 (Volume 65, Number 160)] page 50365

<sup>2</sup> [Federal Register: August 17, 2000 (Volume 65, Number 160)] page 50366



## B. Standard Transactions, Privacy and Security Requirements

The HIPAA Administrative Simplification statutes (42 U.S.C. Secs. 1320d - 1320d-8) authorized the Department of Health and Human Services ("DHHS") to publish an integrated set of regulations for transactional, security and privacy practices to be applied to covered entities. The regulations are intended to promote greater efficiency and patient confidentiality within the healthcare industry. DHHS issued final rules for transactions in August of 2000, privacy in April of 2001, and security in March, 2003.

The core requirements of the rules are as follows:

### Transactions

- Eight *mandated transaction standards* including a healthcare claim and two payment transactions must be conducted in compliance with the Implementation Guidelines specified by DHHS, if done electronically by covered entities after the implementation deadline. The deadline was October 16, 2002 but covered entities that filed a compliance extension plan with DHHS by that date received an extension until October 16, 2003.
- Health plans and healthcare providers can outsource their standardization issues to a Healthcare Clearinghouse, if they do not wish to take on the internal responsibility for conforming to the standard formats. The rule mandating standard formats has an exception for plans and providers who send non-standardized electronic transactions to a Healthcare Clearinghouse that translates the transactions into the standard format and forwards them on its customers' behalf.

### Privacy

- Health plans and healthcare providers are required to comply with the *HIPAA privacy rules* by the implementation deadline for those rules (April 2003). These rules include:
  - Requirements for the confidentiality and management of protected individually-identifiable patient data, called Protected Health Information ("PHI"),
  - Mandated disclosure to patients about the uses and disclosures of their data,
  - Procedures for obtaining, recording and conforming to patient consents to use or disclose that data,
  - Administrative procedures for management and training to support these functions, and,
  - Detailed requirements that *vendors (which may include financial institutions)*, called "*Business Associates*", who receive and use that data, provide contractual assurances that they also will maintain the confidentiality of the data and comply with the applicable restrictions.



Healthcare Clearinghouses are required to conform to a *subset* of those rules when acting as Business Associates for health plans or healthcare providers, and to *all* of the rules when processing protected health information on their *own* account.

**Comment:**

*Regardless of whether a bank is considered a "clearinghouse", many bank customers will determine that their banks are vendors subject to the "Business Associate" requirements of HIPAA's privacy and security rules. This will be clarified in Section IV B, "When is a Bank a 'Business Associate' under HIPAA?"*

**Security**

- Covered entities are required to comply with the **HIPAA security rules** by the implementation deadline for those rules (April 21, 2005). The security rules require that each covered entity must:
  - Ensure confidentiality, integrity, and availability of electronic PHI.
  - Protect against any reasonably anticipated threats or hazards to the security or integrity.
  - Protect against any non-permitted disclosures.
  - Ensure compliance by its workforce.

**Comment:**

*For additional information created by the HIPAA Banking Task Force on the Security Regulation see [HIPAAbanking.org/XXXXX](http://HIPAAbanking.org/XXXXX)*

**IV. Banking Industry Issues under HIPAA**

The extent to which banks are impacted by HIPAA will depend upon the answers to the following questions:

- A) When is a bank a "Healthcare Clearinghouse" under HIPAA? and,
- B) When is a bank a "Business Associate" under HIPAA?

These are not mutually exclusive findings as most Healthcare Clearinghouses are also Business Associates.



## A. When is a Bank a "Healthcare Clearinghouse" under HIPAA?

### Introduction

#### *Background on Healthcare Clearinghouses*

Healthcare Clearinghouses can have either healthcare providers or health plans or both as customers. Those serving providers often capture a print image of a paper claim form at the provider site, edit the claim data for errors or required codes, and reformat the claim to meet the unique data layout requirements of various health plans. Health plan-oriented clearinghouses provide claims receipt services for health plans, which may delegate the entire task of trading partner acquisition and testing to their clearinghouses for a fee. Clearinghouses can serve both the health plan and provider markets. This is the type of company that clearly was at the forefront of DHHS's intent when the statute's definition of "Healthcare Clearinghouse" was drafted.

#### *Background on the Banking Industry's Automated Clearinghouse Network*

Banks commonly use the term "clearinghouse" to refer to a facility for the exchange of payment information. There are local and regional check clearinghouses in which paper checks are exchanged and settled in accordance with rules developed by the members. Perhaps better known and more important in this context is the Automated Clearing House ("ACH"), a network for the exchange of payment and related remittance information that operates under a uniform set of rules developed and administered by NACHA on behalf of more than 12,000 financial institutions and the Federal Reserve. Despite the similarity in their names, the business function of the ACH is completely distinct from that of a Healthcare Clearinghouse. An ACH does not itself take responsibility for any data conversion. The processing of payment files by NACHA member banks is more focused on routing standard files to effect payment rather than transforming or reformatting files as a service. The routine processing of NACHA files by member banks may require some editing to ensure that the message is routed correctly but these routine payment functions are clearly different (and substantially less expensive) than the services provided by Healthcare Clearinghouses.

NACHA, the ABA and the HIPAA Banking Industry Task Force believe that no bank is a clearinghouse under HIPAA by mere origination or receipt of an ACH transaction for relevant HIPAA standard transactions (premium and claim payments). Although banks may originate or receive HIPAA standard transactions such as the Healthcare Claim Payment (835) and Premium Payment (820), they will often pass the related remittance data without any responsibility for conversion or reformatting of the X12 message contained in the NACHA CTX "envelope". Although the messages might be HIPAA standard transactions, the bank may provide only





transport and payment functions. These are the customary services purchased from banks by companies in many industries including healthcare.

#### *Background on Additional Banking Services*

A small number of banks may provide additional services for their healthcare customers. Some health plans and providers may pay banks to provide additional support services by translating or editing files to meet the criteria specified in the *HIPAA Implementation Guidelines*. Banks will be clearinghouses when they choose to provide services that translate files from non-standard to HIPAA-compliant standard formats as requested by customers. Other banks provide "lockbox" services where the bank picks up checks and remittance advices directly from the postal service, deposits the checks and performs some scanning, photocopying and key entry of remittance data. This information may be transmitted electronically in a variety of formats to the customer but this data capture service is not a clearinghouse operation because there is no conversion from an incoming electronic format.

#### **Comment:**

*Most payment services provided by banks do not classify a bank as a Healthcare Clearinghouse regulated by HIPAA. There is, in fact, a specific exclusion in the regulation for payment activities.*

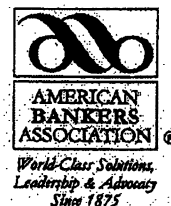
*"Finally, Section 1179 of the Act makes the above provisions inapplicable to financial institutions or anyone acting on behalf of a financial institution when "authorizing, processing, clearing, settling, billing, transferring, reconciling, or collecting payments for a financial institution."<sup>3</sup> Additional information about the scope of the 1179 exemption can be found at <http://www.hipaabanking.org/healthcare.html>.*

*However, some banks may choose to perform specific value-added data translation services, (see page 11) either bundled with or separate from ACH services, that qualify the bank as a HIPAA "Healthcare Clearinghouse". This White Paper provides guidelines for readers regarding when a bank is or is not a clearinghouse under HIPAA.*

*The Banking Industry HIPAA Task Force developed a specific test to determine when banks are or are not considered as Healthcare Clearinghouses under HIPAA. The proposed guidelines for Bank Clearinghouse Status Determination below will allow the reader to determine under what circumstances banks are required to be HIPAA-compliant as a Healthcare Clearinghouse and will indicate what services are "specific value-added" and "clearinghouse-like activities" contrasted with routine payment processing exempted under section 1179.*

---

<sup>3</sup> [Federal Register: August 17, 2000 (Volume 65, Number 160)] [Rules and Regulations] [Page 50313]  
July, 2003



### Proposed Guidelines for Bank Healthcare Clearinghouse Status Determination

The purpose of the proposed guidelines for bank Healthcare Clearinghouse status determination is to provide a clear presentation of the banking industry's position on its Healthcare Clearinghouse status under HIPAA. A specific test must be applied to determine if a bank is or is not a Healthcare Clearinghouse. The test is based upon services provided and should be documented by contractual agreements between banks and their customers.

The following explanation of the guidelines is divided into two sections:

- The Bank Is a Healthcare Clearinghouse and,
- The Bank Is Not a Healthcare Clearinghouse.

Within each section, the reader will find:

1. A general description of the banking functionality related to the section and,
2. Specific case studies illustrating real life situations and determinations of Healthcare Clearinghouse status based on the facts presented in the case study.

#### **Basic Tests**

The test question for a bank to be classified as a Healthcare Clearinghouse or not is: "Is the bank editing or reformatting data against the specifications of the *HIPAA Implementation Guidelines*?"

If the answer is "YES" then the bank is a Healthcare Clearinghouse.

Other edits or reformatting tasks performed by financial institutions against X12 and NACHA requirements are part of routine payment processing.

Today most contracts between banks and their customers do not have language that specifies whether the bank is defined as a Healthcare Clearinghouse. The Task Force recommends that contracts between banks and their customers have standard clauses that clearly state that the bank *is* or *is not* a Healthcare Clearinghouse under HIPAA.

The test question can be applied to many different scenarios and allow for a clear delineation between routine payment processing and Healthcare Clearinghouse services.

#### **The Bank Is a Healthcare Clearinghouse**

1. Originating Depository Financial Institutions ("ODFIs") that contract with "covered entity" customers to convert any of the HIPAA mandated transactions in proprietary data formats to



HIPAA-compliant standard formats *are* clearinghouses under the HIPAA regulations if the following condition applies:

- a) The bank is editing or reformatting files for its customers using the *HIPAA Implementation Guidelines* as the source of edits.
2. Receiving Depository Financial Institutions (“RDFIs”) that contract with “covered entities” to convert HIPAA-compliant standard transactions received to non-HIPAA-compliant formats required by the customer are Healthcare Clearinghouses if the following condition applies:
- a) The bank is editing or reformatting files for its customers using the *HIPAA Implementation Guidelines* as the source of edits.

## Test Cases

The following Healthcare Clearinghouse Determination Test Cases are appropriate to illustrate application of the above test question and present typical payment processing routines and value-added services that would classify the bank as a Healthcare Clearinghouse and a covered entity under HIPAA. The cases are presented in two groups based on services for either outgoing (ODFI) or incoming (RDFI) payments.

## Originating Depository Financial Institution

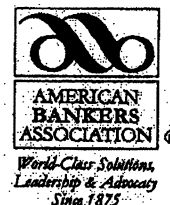
### Case One

- A Health Plan sends a proprietary flat file with healthcare claim payments and the ODFI reformats the data into the X12 835 standard and further manipulates the data to create a properly formatted CTX (NACHA format). The properly formatted NACHA file is then submitted to the ACH Network for processing. The Bank has contracted with its customer to provide a HIPAA-compliant transaction as determined by the *HIPAA Implementation Guidelines*.

#### Edits or Reformatting

- Edits applied: *HIPAA Implementation Guidelines*, X12 and NACHA
- Reformatting: Proprietary to X12 and to NACHA

**Determination:** The Bank *is* a Healthcare Clearinghouse because it *is* reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.



## Receiving Depository Financial Institution

### Case Two

- An RDFI receives multiple NACHA files via the ACH Network. These CTX files are bound for the same provider Payee. The RDFI merges the properly formatted CTX files into a consolidated file to send to the intended provider. The RDFI also received 835 files from Value Added Networks that are to be re-associated with payment data sent separately. The resulting, merged transactions are then sent to the receiver in an 835 format. The provider has asked the bank to edit the incoming 835 files against the *HIPAA Implementation Guidelines* and to manage the receipt or rejection processing of the 835 data in addition to performing payment processing services.

#### **Edits or Reformatting**

- Edits applied: NACHA, X12 and *HIPAA Implementation Guidelines*
- Reformatting: NACHA to X12

**Determination:** Bank *is* a Healthcare Clearinghouse because it *is* reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

### **The Bank Is Not a Healthcare Clearinghouse**

The banking industry has been providing payment processing services for decades and has significant regulations and responsibilities for standards-based payment processing. Banks provide occasional file editing and reformatting functionalities in the routine course of payment processing. It is proposed that DHHS recognize that such traditional payment services between banks and their healthcare customers *do not* constitute Healthcare Clearinghouse activities. If the customer does not want to require its bank to perform *HIPAA Implementation Guidelines* compliance checking against incoming or outgoing payment files it would be inappropriate to classify the bank as a Healthcare Clearinghouse for its completion of routine payment services provided to customers in all other industries.

## Originating Depository Financial Institution

1. ODFIs whose customers ask them to originate payments with banking industry standard editing and reformatting functionalities *are not* Healthcare Clearinghouses under HIPAA. These banks are contractually obligated to effect payment and move remittance data and are not contractually responsible for editing or reformatting payment data against the *HIPAA Implementation Guidelines*.



- a) ODFIs can accept NACHA files from customers, with or without HIPAA-compliant remittance data enclosed, without being defined as a Healthcare Clearinghouse.
- b) Reformatting from X12 to NACHA or from a proprietary format to NACHA for payment processing does not constitute Healthcare Clearinghouse activity.
- c) Editing and supplementing payment data for completeness against X12 and NACHA standards alone does not constitute Healthcare Clearinghouse activity.

### Receiving Depository Financial Institution

1. RDFIs that merely receive payments in any NACHA format and route any data to customers based on a variety of routing instructions are *not* Healthcare Clearinghouses under HIPAA.
  - a) RDFIs can accept NACHA files, with or without HIPAA-compliant remittance data enclosed, without being a Healthcare Clearinghouse.
  - b) Reformatting from NACHA files to X12, BAI or proprietary formats and routing of remittance data to customers does not constitute Healthcare Clearinghouse activity.
  - c) Editing and supplementing data for completeness against X12 and NACHA standards alone does not constitute Healthcare Clearinghouse activity.

### Test Cases

The following Test Cases illustrate typical payment processing routines that would *not* classify the bank as a Healthcare Clearinghouse and a covered entity under HIPAA. The cases are presented in two groups based on services for either outgoing (ODFI) or incoming (RDFI) payments.

### Originating Depository Financial Institution

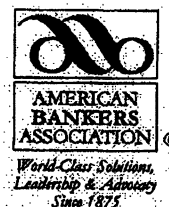
#### Case Three

- A health plan sends a properly formatted CTX (NACHA format) to its ODFI containing a Healthcare Claim Payment/Advice (835) transaction, and the ODFI submits the transaction to the ACH Network.

#### Edits or Reformatting

- Edits applied: NACHA
- Reformatting: None

**Determination:** Bank *is not* a Healthcare Clearinghouse because it *is not* reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.



#### Case Four

- A health plan sends a properly formatted Healthcare Claim Payment/Advice (835) transaction to the ODFI, and the ODFI places the properly formatted 835 into the CTX (NACHA format) and submits the transaction to the ACH Network.

##### **Edits or Reformatting**

- Edits applied: X12
- Reformatting: X12 to NACHA

**Determination:** Bank *is not* a Healthcare Clearinghouse because it *is not* reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

#### Receiving Depository Financial Institution

#### Case Five

- An RDFI receives a properly formatted CTX (NACHA format) via the ACH Network. That NACHA file is then passed on to the provider receiver (payee).

##### **Edits or Reformatting**

- Edits applied: NACHA
- Reformatting: None

**Determination:** Bank *is not* a Healthcare Clearinghouse because it *is not* reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

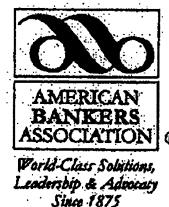
#### Case Six

- An RDFI receives a properly formatted CTX (NACHA format) via the ACH Network and extracts the 820 or 835 from that CTX file. That 820 or 835 is then passed on to the provider receiver (payee).

##### **Edits or Reformatting**

- Edits applied: NACHA and X12
- Reformatting: NACHA to X12

**Determination:** Bank *is not* a Healthcare Clearinghouse because it *is not* reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.



## Case Seven

- An RDFI receives a properly formatted CTX (NACHA format) via the ACH Network. Pertinent data in the CTX file is then passed on to the provider receiver (payee) via Human Readable Methodology.

***Comment: Human Readable Methodology includes, but is not limited to, FAX, E Mail, Print Advice, Bank Statement, Information Reporting Terminal or Software (whether supplied by the Financial Institution or not). This Human Readable Methodology might also include pre-formatted - Internet based and other future technologies. Banks and their customers must establish HIPAA-compliant secure communications for the dissemination of any human readable information.***

### **Edits or Reformatting**

- Edits applied: NACHA and X12
- Reformatting: NACHA to X12 to Human Readable

**Determination:** Bank *is not* a Healthcare Clearinghouse because it *is not* reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

Financial Institutions are required by ACH Network rules<sup>4</sup> promulgated by NACHA to forward payment related information to receivers upon request. This is, therefore, a normal (and required) function of the payment network. Banks and their customers must establish HIPAA-compliant secure communications for the dissemination of this human readable information.

## Case Eight

- Paper Healthcare Claim Payment data in the form of Explanation of Benefit/Remittance Advices statements sent from a health plan to a provider are keyed in a Lockbox processing area within the Bank and sent electronically in a BAI or X12 format to the provider receiver (payee). Images of the items received in the lockbox are also sent to the payee, or otherwise made available upon request.

### **Edits or Reformatting**

---

<sup>4</sup> NACHA ACH Network Operating Rules - Article Four, Subsection 4.4.3 – Provision of Payments-Related Information to Receiver.



- Edits applied: None
- Reformatting: Not applicable as paper is not an electronic format whose data can be “reformatted”. Similarly, the creation of images of paper transactions is not a “reformatting” of data.

**Determination:** Bank *is not* a Healthcare Clearinghouse because it *is not* reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

#### Case Nine

- An RDFI receives a properly formatted CTX (NACHA format) via the ACH Network. Paper transactions keyed in at Lockbox Processing Operations at the bank are then merged with 820 or 835 data. The resulting 820 or 835 is then transmitted to the receiver (payee).

##### **Edits or Reformatting**

- Edits applied: NACHA or X12 to CTX transmission, none to Lockbox Data
- Reformatting: NACHA to X12

**Determination:** Bank *is not* a Healthcare Clearinghouse because it *is not* reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

Financial Institutions, as a normal course of business, receive payments via various methodologies (ACH, Wire, Check, et al) and must report on these payments in a manner consistent with the capabilities of the receiver’s (payee’s) accounts receivable system(s). Banks routinely merge data files and forward a “consolidated” file to the receiver to streamline and simplify the reconciliation process. The customer in this example is not requesting the bank to edit or reformat incoming data against *HIPAA Implementation Guidelines*.

#### Case Ten

- An RDFI receives a NACHA formatted file (CCD or CCD+) via the ACH network. The RDFI receives an 820 or 835 from an external network or third party healthcare provider for re-association purposes. The resulting, re-associated transactions are then sent to the receiver (payee) in an 820 or an 835 format.

##### **Edits or Reformatting**

- Edits applied: NACHA or X12
- Reformatting: NACHA to X12





**Determination:** Bank *is not* a Healthcare Clearinghouse because it *is not* reformatting and editing the data against the requirements of the *HIPAA Implementation Guidelines*.

Financial Institutions, as a normal course of business, receive payments and payment related information from multiple sources. Banks routinely re-associate payments received from the ACH Network with payment related information received from a third party network or service provider and merge these data files for reconciliation purposes. This merged file is then sent to the Receiver. The customer in this example is not paying for the bank to edit or supplement incoming data against *HIPAA Implementation Guidelines*.

Based on the answers to the Basic Test and Test Case evaluations presented in Section A, the reader will be able to determine if the bank *is* or *is not* a Healthcare Clearinghouse. The reader should now address the second question "When is a bank a 'Business Associate' under HIPAA?" to determine to what extent a bank is impacted by HIPAA in this regard.



## **B. When is a Bank a "Business Associate" under HIPAA?**

### **Introduction**

#### *Background on Business Associates*

The Banking Industry HIPAA Task Force identified a need to clarify the application of the Business Associate relationship to banking services. It is recognized that banks may be deemed "Business Associates" of HIPAA covered entities such as health plans and providers when the banks process payment transactions/remittance data containing PHI. Health plan and provider customers will therefore seek to revise existing bank contracts to incorporate applicable HIPAA Privacy and Security requirements for banks as Business Associates. To assist the banking industry, the Banking Industry HIPAA Task Force has developed, with the assistance of several financial institution attorneys, a banking industry version of Model Business Associate Contract provisions available at [http://www.hipaabanking.org/bus\\_contract.html](http://www.hipaabanking.org/bus_contract.html)

#### *Background on the HIPAA Privacy Rule*

The HIPAA Privacy Rule requires health plans and providers to enter into "Business Associate contracts" with their vendors and service providers who use, disclose, or store protected health information, regardless of whether those third parties are "Healthcare Clearinghouses." Healthcare Clearinghouses are Business Associates of providers or health plan customers under the HIPAA Privacy Rule. Under the Privacy Rule, in most situations, there are no additional requirements for Healthcare Clearinghouses other than those applicable to other Business Associates. Protected health information broadly covers patient medical data and can include payment remittance data. Demographic data about patients such as name and address, or patient IDs will be deemed "protected" if associated or associatable with a provider name, treatment or product description, or other data from which medical facts about the patient may be inferred.

*The Banking Industry HIPAA Task Force developed a specific test to determine when banks are or are not considered Business Associates under HIPAA. The proposed guidelines for Bank Business Associate Status Determination below will allow the reader to determine under what circumstances banks are Business Associates or are not Business Associates.*

#### *Proposed Guidelines for Bank Business Associate Status Determination*

The purpose of the proposed guidelines for bank Business Associate status determination is to provide a clear presentation of the banking industry's position on its Business Associate status under HIPAA. Two questions must be answered to determine if a bank is or is not a Business Associate.



The following explanation of the guidelines is divided into two sections:

- The Bank Is a Business Associate and,
- The Bank Is Not a Business Associate

Within each section, the reader will find specific case studies illustrating real life situations and determinations of Business Associate status based on the facts presented in the case study.

### **Basic Test**

Today most contracts between banks and their customers do not have language that specifies whether the bank is defined as a Business Associate. It is recommended that contracts between banks and their customers have standard clauses that clearly state that the bank *is* or *is not* a Business Associate under HIPAA. It is the responsibility of the covered entity to negotiate a Business Associate agreement with its bank.

The test questions for Business Associate determination will be the following:

“Does the bank have access to PHI and does its customer have a contractual agreement that defines the bank as a Business Associate?”

If the answer to the test question is “YES” to both these questions than the bank is a Business Associate.

These test question can be applied to many different scenarios and allow for a clear delineation of when a bank is a Business Associate.

### **The Bank Is a Business Associate**

The following text is taken from the HIPAA Privacy Rule and it provides a definition of the Business Associate.

#### **45 CFR Sec. 160.103**

“a person who ...

- ... Performs [for a covered entity], or assists [a covered entity] in the performance of ... a function or activity involving the use or disclosure of individually identifiable health information, including claims processing or administration, data analysis, processing or administration, utilization review, quality assurance, billing, benefit management, practice management, and repricing; or
- ... Any other function ... regulated by this subchapter; or
- ... provides ... legal, actuarial, accounting, consulting, data aggregation ... management, administrative, accreditation, or financial services ... to [a] covered entity, ... [that ] involves the disclosure [of] individually identifiable health information ...



## Test Cases

The following Business Associate Determination Test Cases are appropriate to illustrate application of the above test question and present typical banking services and contractual relationships that would classify the bank as a Business Associate under HIPAA.

### Case Eleven

- A Health Plan sends a proprietary flat file with healthcare claim payments and the ODFI reformats the data into the X12 835 standard and further manipulates the data to create a properly formatted CTX (NACHA format). The properly formatted NACHA file is then submitted to the ACH Network for processing. The Bank has contracted with its customer to provide a HIPAA-compliant transaction as determined by the *HIPAA Implementation Guidelines*. The contract between the Bank and its customer indicates that the Bank is a Business Associate. The bank has access to Protected Health Information because of the PHI contained in the 835 HIPAA Standard Transaction sent by the health plan to the bank.

#### **Contractual Requirement**

- Contractual Requirement for Business Associate Determination: Corporate Service Contract states that the bank is a Business Associate.

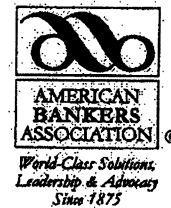
#### **Access to PHI**

- The bank has access to PHI

**Determination:** The Bank *is* a Business Associate because the answers to the test questions are positive. The contract between the bank and its customer does specify that the bank is a Business Associate, and the Bank does have access to PHI. As mentioned earlier, clearinghouses are also Business Associates and in this example the bank is both a clearinghouse and a Business Associate. Case eleven and case one are the same in order to clearly illustrate that a clearinghouse is a Business Associate.

### Case Twelve

- An RDFI receives multiple NACHA files via the ACH network. These CTX files are bound for the same Provider Payee. The RDFI merges the properly formatted CTX files into a consolidated file to send to the customer. The RDFI also received 835 files from Value Added Networks that are to be re-associated with payment data sent separately. The resulting, merged transactions are then sent to the Receiver in an 835 format. The customer has asked the bank to edit the incoming 835 files against the *HIPAA Implementation Guidelines* and to manage the receipt or rejection processing of the 835 data in addition to



performing payment-processing services. The contract between the Bank and its customer indicates that the Bank is a Business Associate when the Bank has access to Protected Health Information through the data contained in the 835 HIPAA Standard Transaction.

**Contractual Requirement**

- Contractual Requirement for Business Associate Determination: Corporate Service  
Contract states that the bank is a Business Associate.

**Access to PHI**

- The bank has access to PHI

**Determination:** The Bank *is* a Business Associate because the answers to the test questions are positive. The contract between the bank and its customer does specify that the bank is a Business Associate. As mentioned earlier, clearinghouses are also Business Associates and in this example the bank is both a clearinghouse and a Business Associate. Case twelve and case two are the same in order to clearly illustrate that a clearinghouse is a Business Associate.

**Case Thirteen**

- A health plan sends a properly formatted CTX (NACHA format) containing a Healthcare Claim Payment/Advice (835) transaction and the ODFI passes on the received NACHA file to the ACH Network. The contract between the Bank and its customer indicates that the Bank is a Business Associate. The bank has access to Protected Health Information because of the PHI contained in the 835 HIPAA Standard Transactions sent by the health plan to the bank.

**Contractual Requirements**

- Contractual Requirement for Business Associate Determination: Corporate Service  
Contract states that the bank is a Business Associate.

**Access to PHI**

- The bank has access to PHI

**Determination:** The Bank *is* a Business Associate because the answers to the test questions are positive. The contract between the bank and its customers does specify that the bank is a Business Associate. The Bank has access to PHI. Unlike the two prior examples the bank is not a Healthcare Clearinghouse because data translation and validation against the *HIPAA Implementation Guide* have not occurred. Case thirteen and case three are the same in order to clearly illustrate a circumstance where the bank is not a clearinghouse and is a Business Associate.



## Case Fourteen

- Paper Healthcare Claim Payment data in the form of Explanation of Benefit/Remittance Advice statements sent from a health plan to a provider are keyed in a Lockbox processing area within the Bank and sent electronically in a BAI or X12 format to the provider receiver (payee). Images of the items received in the lockbox are also sent to the payee. The contract between the Bank and its customer indicates that the Bank is a Business Associate. The bank has access to Protected Health Information because of the PHI contained in the 835 HIPAA Standard Transactions and the PHI contained in paper Explanation of Benefit/Remittance Advice statements.

### **Contractual Requirement**

- Contractual Requirement for Business Associate Determination: Corporate Service  
Contract states that the bank is a Business Associate.

### **Access to PHI**

- The bank has access to PHI

**Determination:** The Bank *is* a Business Associate because the answers to the test questions are positive. The contract between the bank and its customers does specify that the bank is a Business Associate. The Bank has access to PHI. In this example the bank is not a Healthcare Clearinghouse because data translation and validation against the *HIPAA Implementation Guide* have not occurred. Case fourteen and case eight are the same in order to clearly illustrate a circumstance where the bank is not a clearinghouse and is a Business Associate.

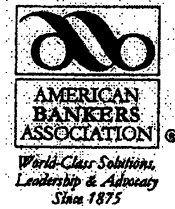
## **The Bank Is Not a Business Associate**

### **Test Cases**

The following Business Associate Determination Test Cases are appropriate to illustrate application of the test question and present typical banking services that *would not* classify the bank as a Business Associate under HIPAA.

## **Case Fifteen**

- A health plan uses a bank for a variety of services specifically:
  - Trust Safekeeping and custody of investment securities
  - Investment Services (Advice and trade executions)
  - Payroll processing



The contract between the Bank and its health plan customer indicates that the Bank is not a Business Associate. The bank has no access to Protected Health Information.

**Contractual Requirement**

- Contractual Requirement for Business Associate Determination: The Corporate Service Contract between the bank and its customer has no specification that the bank is a Business Associate.

**Access to PHI**

- The Bank does not have access to PHI

**Determination:** The Bank *is not* a Business Associate because the answers to the test questions are negative. The contract between the bank and its customers does not specify that the bank is a Business Associate. The Bank has no access to PHI.



### **About the ABA**

The American Bankers Association ("ABA") is a not-for-profit trade association that brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and bank holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

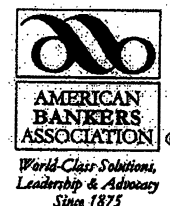
### **About NACHA**

NACHA - The Electronic Payments Association is the leading organization in developing electronic solutions to improve the payments system. NACHA is a not for profit association that represents more than 12,000 financial institutions through direct memberships and a network of regional payments associations, and 650 organizations through its industry councils. NACHA develops operating rules and business practices for the Automated Clearing House ("ACH") Network and for electronic payments in the areas of Internet commerce, electronic bill and invoice presentment and payment (EBPP, EIPP), e-checks, financial electronic data interchange ("EDI"), international payments, and electronic benefits transfer ("EBT").

### **Background on the NACHA/ABA Banking Industry HIPAA Task Force**

The Banking Industry HIPAA Task Force was created by NACHA and the ABA. Together, the ABA and NACHA--The Electronic Payments Association, represent all payment processing financial institutions that may process HIPAA claim and premium payment transactions. Recognizing the need for industry consensus and leadership on HIPAA the ABA and NACHA assembled an expert panel and created The Banking Industry HIPAA Task Force.





## About MMI

The Banking Industry HIPAA Task Force enlisted the services of McLure-Moynihan, Inc. ("MMI") a Healthcare EDI and HIPAA consulting and services firm, to facilitate meetings on the impact of HIPAA on the Banking Industry and to write the White Paper on HIPAA Related Issues affecting the Banking Industry. Marcia McLure Ph.D, Jamie Clark JD and John Matthews CCM, MBA of MMI made significant contributions to the development of the paper.

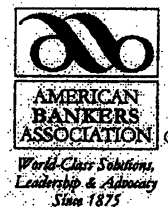
**James Moynihan, MBA**, of MMI was the primary participant from MMI within the Banking Industry HIPAA Task Force and the principle author of the White Paper. Prior to founding MMI, Mr. Moynihan was a banker for 15 years with Irving Trust Company and First Chicago. Mr. Moynihan is one of the founding members of ANSI ASC X12N and was one of the first Co-chairs of the Payments Work Group that created the ASC X12 835 Healthcare Claim Payment/Advice, which is one of the two Standard Transaction for payment under HIPAA. McLure-Moynihan, Inc. has implemented both of the HIPAA mandated standard payment transactions and brought practical experiences to bear in the preparation of this White Paper.

Mr. Moynihan has written and lectured widely on HIPAA and its requirements.

**Marcia L. McLure Ph.D.** is a Principal and Senior Consultant at MMI. Dr. McLure is a member of ANSI ASC X12 and was Co-Chair of the X12N Healthcare Transactions Steering Work Group from 1993 to 1996. During that time, the X12N subcommittee developed several Type Two X12 documents that are still valuable today, including "EDI Transactions: A Business Primer" and "The Healthcare Industry Transaction Blueprint", a messaging model for the Healthcare industry for all X12 transactions. Dr. McLure also co-chaired the Medical Stop Loss Work Group from 1996 to 1998. She also served as co-chair of the X12N Medical Stop Loss Work Group and is currently serving on the ebXML Initiative that is working on the evolution of international Internet and technologies. Dr. McLure was the Team Lead for the Business Process Project Team and Delivery Team within the Electronic Business XML (*ebXML*) project and a member of the ebXML Steering Committee.

Dr. McLure earned her Ph.D. from UCLA. Her specialty area is Research Methods and Evaluation ("RME") with a cognate in Business Management and Policy from the UCLA Anderson School of Management

**Jamie Clark JD** is Vice President and the General Counsel of MMI. Mr. Clark is the current chairman of the Electronic Commerce Subcommittee of the American Bar Association's Business Law Section, and co-chair of the health information task force of its Privacy Subcommittee. He is a co-author of the recently-released open business process standards documents for the international Electronic Business XML ("*ebXML*") joint project of UN/CEFACT and OASIS. He is also a member of the U.S. Delegation to the United Nations Commission on International Trade Law ("*UNCITRAL*") expert panel on Electronic Commerce.



He is a frequent speaker on information use confidentiality and security standards, HIPAA implementation, electronic signatures and automated contracting.

He received a B.S. degree in 1980 from the University College, University of Minnesota, and a J.D. degree *cum laude* in 1988, from the University of Minnesota Law School. He joined Shearman & Sterling on Wall Street upon graduation and practiced as a corporate lawyer handling complex financial transactions in New York and Los Angeles. Prior to joining MMI, he was a partner in the corporate practice of a small law firm in Los Angeles, primarily responsible for acquisitions, supply chain contracts and software transactions.

**John Matthews** is Vice President of Technology for MMI. Mr. Matthews and was the Co-chair of the Insurance Subcommittee from 1990 to 1993. He is the former representative of the ANSI ASC X12 organization to HISPP, the Healthcare Information Systems Planning Panel, a body that is coordinating the development of clinical and financial EDI standards across such organizations as ACR-NEMA, IEEE, NCPDP, HL7 and others.

Prior to joining MMI in 1994, Mr. Matthews was a vice president and project manager for Mellon Bank. His project management responsibilities for the bank included the multi-million dollar Global Cash Management Office Automation Project, installing a LAN for over 400 in-house users, and the development of a variety of software-based cash management products. He was also responsible for implementing secure remote access capabilities. In that role Mr. Matthews also worked to evaluate new technologies to determine their effectiveness, appropriateness and feasibility in a financial transactions environment.

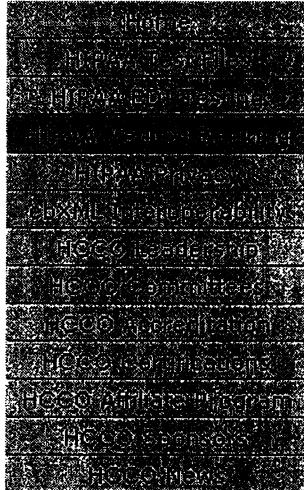
Mr. Matthews earned his B.A. degree in Economics and his M.B.A from the University of Pittsburgh. He is also a Certified Cash Manager ("CCM").



# HCCO

## HIPAA Conformance Certification Organization

### HIPAA Accreditation and Certification Services



### HIPAA Medical Banking

HCCO offers healthcare covered entities, financial institutions and their business partners a specific HIPAA Medical Banking Certification. This industry leading certification is focused solely on the capability of institutions to properly handle the 835 and 820 HIPAA transaction sets. HCCO has created very specific test conditions to evaluate the HIPAA readiness of healthcare organizations in dealing with the financial aspects of HIPAA. The HCCO Medical Banking Certification is designed for all inbound and outbound aspects of HIPAA testing for covered entities, financial institutions and their business partners.

The Medical Banking Certification is built upon HCCO's industry best CCAP testing methodology which used by over 80% of healthcare EDI translation and EDI validation technology. This ensures transaction interoperability among most of the industry leading payers, providers and clearinghouses. The Medical Banking Program provides unlimited online testing using the HCCO HIPAA testing engine, monthly test files and expected results, compliance issue resolution and HCCO Medical Banking Certification for all participants.

#### Download an Overview to the CCAP Methodology

Sign up today and take part in the most innovative and fastest growing HIPAA compliance program for healthcare.

For additional information on how HCCO's Medical Banking Certification will enable your organization's financial goals, please contact [admin@hcco.us](mailto:admin@hcco.us).

To pay by credit card for the Medical Banking Certification Program, click the button below.

### HCCO Medical Banking Test Files and Certification \$295.00

**Buy Now**

☒ HCCO's testing program uses all facets of testing, from test files to test plans to expected results. No other certifier uses this combined methodology.

☒ Keep current on EDI validation issues

☒ Stay in synch with the nation's leading EDI Translators and Validators

☒ The Medical Banking program includes thousands of HIPAA test conditions



[Privacy Policy](#) | [Contact Us](#)

[ [HIPAA Test Files](#) ] [ [HIPAA EDI Testing](#) ] [ [HIPAA Medical Banking](#) ]  
[ [HIPAA Privacy](#) ] [ [ebXML Interoperability](#) ] [ [HCCO Leadership](#) ]  
[ [HCCO Committees](#) ] [ [HCCO Accreditation](#) ] [ [HCCO Certifications](#) ]  
[ [HCCO Affiliate Program](#) ] [ [HCCO Sponsors](#) ] [ [HCCO News](#) ]

1225 W Main St. Suite 101-202, Mesa, AZ. 85201  
[webmaster@hcco.us](mailto:webmaster@hcco.us)

Copyright © 2002, 2003, 2004 HCCO, Inc.



## HIPAA—Application to the Banking Industry

The *Health Insurance Portability and Accountability Act of 1996* (HIPAA) is intended, among other things, to improve portability of health insurance coverage, to protect the privacy of individual health information, and to simplify and improve the efficiency of administering health insurance. HIPAA defines and regulates “covered entities” that may be healthcare providers or healthcare plans, healthcare clearinghouses, or business associates (third-party vendors used by covered entities).

To understand HIPAA’s impact on financial institutions, the American Bankers Association (ABA) and NACHA—The Electronic Payments Association created the *Banking Industry HIPAA Task Force* (Task Force) and engaged knowledgeable industry participants to review HIPAA and accurately interpret its coverage and related financial institution responsibilities.

### HIPAA’s IMPACT ON FINANCIAL INSTITUTIONS

HIPAA may impact financial institutions in two ways.

*First*, HIPAA sets transaction standards for the electronic processing of healthcare claims and payments. At this point, it is unclear whether payment processing activities related to health care that use these standards would make financial institutions “covered entities” subject to HIPAA.

*Second*, HIPAA establishes requirements for the privacy of personally identifiable “protected health information” (PHI) and security policies for the storage and transmission of that information. Financial institutions that process PHI for their customers that are covered entities may be “business associates” subject to the privacy and security provisions of HIPAA. These HIPAA requirements may conflict with federal banking law.

ABA and NACHA are cooperating to obtain critical clarification of these issues from the Department of Health and Human Services (HHS), the agency that implements and enforces HIPAA.<sup>1</sup>

***Need for immediate action.*** HIPAA requires that all covered entities be in compliance with its provisions effective October 16, 2002, a mere three months from now. However, it is very likely that HHS will not make its determination as to whether payment

---

<sup>1</sup> The Task Force has produced a White Paper to set forth guidelines for financial institutions and their customers to resolve issues of HIPAA compliance. The text of the *White Paper on HIPAA Related Issues Affecting the Banking Industry* can be found on the Banking Industry HIPAA Task Force web page: [www.hipaabanking.org](http://www.hipaabanking.org).

processing activities make financial institutions “covered entities” until after that deadline. HHS will extend that deadline for one year, until October 16, 2003, for institutions that file an extension letter with the agency by October 16, 2002. The extension letter states that if the institution is deemed to be a covered entity, it will be in compliance by October 16, 2003.

The Task Force has drafted a model letter, available at [www.hipaabanking.org](http://www.hipaabanking.org) that financial institutions may use to file for the extension. *Note that the extension should be submitted to HHS via certified mail.*

## **BACKGROUND**

### **Payment Processing**

As part of its objective of simplifying the administration of health insurance and reducing waste in that process, HIPAA sets requirements for processing financial EDI transactions<sup>2</sup> using a uniform electronic standard. HIPAA requires healthcare clearinghouses to edit incoming/outgoing electronic transactions against the HIPAA Implementation Guide.<sup>3</sup> This means that healthcare clearinghouses must edit down to the data element level (*i.e.*, the smallest data segment) and ensure that the all-medical codes utilized in the document are current and correct. If they are not, the transaction is to be rejected and sent back to the originator.

The critical issue for the banking industry is what payment processing activities do – *or do not* – constitute actions of a “covered entity” under HIPAA. It has been suggested by some that a literal interpretation of HIPAA’s definition of a “healthcare clearinghouse” covers financial institutions that, in the normal course of business: (1) receive a payment instruction from a HIPAA-covered entity (*e.g.*, healthcare provider or insurance company), and send an ACH transaction with addenda in a HIPAA-compliant format; or (2) receive an ACH transaction with addenda in a HIPAA-compliant format and pass this information on to a covered entity in a human-readable or other useable format.

**The banking industry does not believe that routine financial EDI processing of healthcare transactions (*e.g.*, premium and claim payments), constitute the actions**

---

<sup>2</sup> Financial EDI transactions are payment transactions accompanied by addenda information to assist processing and reconciliation by the receiving company. These transactions are typically sent through the Automated Clearing House (ACH) Network. The ACH Network is a secure, reliable and cost-effective method of moving both money and data together through the nation’s banking system. The ACH Network serves 20,000 financial institutions, 3.5 million businesses, and 100 million individuals. In 2001, the ACH Network processed 8 billion transactions, of which approximately 170 million were business-to-business financial EDI transactions (with a sizable percentage of these being healthcare-related transactions). Use of financial EDI eliminates the need for senders and receivers to rely on multiple channels to transmit and process payments and payment-related data, and eliminates the need to re-associate the payment and remittance data on the receiving end.

<sup>3</sup> The mandated electronic transactions relevant to financial institutions are the ANSI ASC X12 820 and 835.

of a "healthcare clearinghouse," nor does the industry believe that this was the intent of HIPAA's authors.

*When is a financial institution a "healthcare clearinghouse" under HIPAA?* Among other functions, healthcare clearinghouses serve healthcare providers and/or health plans by editing claim data for errors or required codes, reformatting claims to meet the unique data layout requirements of various health plans, and editing against the HIPAA Implementation Guide. This is the type of company that clearly was intended to be defined as a healthcare clearinghouse in the Act, and the overwhelming majority of financial institutions do not provide this type of service.

Although financial institutions may originate or receive HIPAA standard transactions such as the Healthcare Claim Payment (835) and Premium Payment (820), they will often pass on the related remittance data without any responsibility for conversion or reformatting of the X12 message contained in the NACHA CTX "envelope." Although these messages might be HIPAA standard transactions, the financial institution typically provides only transport and payment functions.

A small number of financial institutions may choose to provide value-added services for their healthcare customers that would fall within the intent of the "healthcare clearinghouse" definition. For example, some health plans and providers may contract with financial institutions for support services whereby files are translated or edited to meet the criteria specified in the HIPAA Implementation Guide. On the receipt side, some financial institutions may provide value-added services that translate specific transactions/addenda from non-standard to HIPAA-compliant standard formats as specifically requested by customers.

Applying a literal interpretation of the "healthcare clearinghouse" definition to routine financial EDI processing would:

- *Subject thousands of financial institutions to coverage as covered entities, resulting in the need to comply with and bear potential liability for HIPAA-related requirements solely by the nature of the underlying transaction they process, rather than their specific intent to provide services contemplated by Congress as those of a covered entity.*
- *Require all financial institutions handling CTX ACH transactions to edit ACH files for healthcare related transactions,<sup>4</sup> thereby dramatically increasing the time and cost of processing, presumably increasing the price for such processing services to at least partially recover this added cost, and reducing the overall efficiency of payments processing, including the processing of financial EDI healthcare transactions.*

---

<sup>4</sup> Currently, there is no way upon receipt of a file containing CTX transactions to determine which transactions are healthcare-related and which are not.



- *Subject financial institutions to potential liability for handling CTX ACH transactions that include improperly formatted HIPAA standard addenda records, where such transactions are not detected and rejected by the financial institution.*
- *Potentially result in the rejection of transactions by financial institutions that the receiver would have translated into proper format upon receipt (i.e., the receiver did not request or contract for this service with its financial institution.)*

### **Privacy and Security Issues**

The proposed HIPAA privacy rule requires health plans and providers to enter into "business associate contracts" with their vendors and service providers who use, disclose, or store personally identifiable protected health information (PHI), regardless of whether those third parties are "healthcare clearinghouses". That rule was finalized on August 14, 2002. PHI broadly covers patient medical data and can include payment remittance data. Demographic data about patients such as name and address, or patient IDs will be deemed "protected" if associated or able to be associated with a provider name, treatment or product description, or other data from which medical facts about the patient may be inferred.

It is clear that financial institutions whose customers are HIPAA "covered entities" (such as health plans and providers) will become "business associates" if they have access to PHI in the normal course of business. Accordingly, those health plan and provider customers will, as required by HIPAA, seek to revise existing bank contracts to incorporate applicable HIPAA privacy and security requirements. The Task Force has determined that some of the HIPAA requirements conflict with provisions of federal banking law and is exploring this issue more fully.

Generally, the banking industry should be well positioned to meet the confidentiality requirements of HIPAA as a result of the significant privacy and information security rules imposed under the Gramm-Leach-Bliley Act.

The Task Force is creating a *Business Associate Contract Guide* that would provide model business contract language that meets HIPAA's requirements as well as appropriate responses to customer requests for amended business contracts. The model contract language would include:

- Standard language for "reasonable assurances" of confidentiality that will be acceptable to financial institutions while meeting legitimate customer needs under
- Definitions of banks' HIPAA responsibilities to maintain records of, and log access to, the relevant patient information in a manner that is minimally disruptive to normal banking operations.

In its review of HIPAA's coverage of financial institution healthcare payment processing, the Task Force determined that:

- The large majority of financial institutions are *not* Healthcare Clearinghouses and therefore *not* covered entities under HIPAA.
- A small number of financial institutions perform value-added services for customers that would classify them as Healthcare Clearinghouses.

The Task Force also determined that:

- Financial institutions providing services to the healthcare industry may often be classified as "business associates" of health plans and providers.
- Financial institutions have a long tradition of protecting confidential financial information and have security practices that meet or exceed many HIPAA requirements for privacy and security.
- HIPAA-related Banking Industry Guidelines could assist financial institutions and their customers to readily determine covered entity status based upon tests, and to adapt existing service contracts with model contract language developed by the Task Force.



**MORRISON & FOERSTER LLP**

**Privileged and Confidential \***

**M E M O R A N D U M**

**TO: Ian Macoy  
NACHA**

**FROM: Oliver Ireland  
Peter Swire  
Morrison & Foerster LLP**

**DATE: March 19, 2003**

**RE: Application of the Health Insurance Portability and Accountability Act  
Rules to Receiving Depository Financial Institutions**

---

You have asked us to examine the treatment of certain activities by a Receiving Depository Financial Institution ("RDFI") under the rules adopted by the Department of Health and Human Services ("HHS") to implement the Health Insurance Portability and Accountability Act of 1996 ("HIPAA Rules"). The factual setting in this memorandum,<sup>1</sup> which we call "ACH Payment Activity," is where an RDFI receives an ACH Entry that includes protected health information as a part of the remittance information in the Entry and provides that information to its Receiver customer in a statement or other form in which the Receiver normally receives information about the receipt of ACH Entries. The legal question addressed here is whether the RDFI would thereby become a health care clearinghouse subject to the requirements in the HIPAA Rules for health care clearinghouses.

Due to the exemption in section 1179 of the HIPAA statute and the definition and explanation of "payment" in the HIPAA Rules, we believe that the HIPAA Rules do not apply to ACH Payment Activity. The definition of "health care clearinghouse" in the HIPAA Rules, taken alone, might seem to apply to ACH Payment Activity, and the HIPAA Rules do not expressly exclude an RDFI from the definition of "health care clearinghouse." Importantly, however, section 1179 of the HIPAA statute itself expressly exempts entities engaged in the activities of a financial institution, or in processing payments for a financial institution, from the coverage of HIPAA. Although the HIPAA Rules limit the information that can be provided to financial institutions for payment purposes, the HIPAA Rules do not purport to interpret the financial institution exemption narrowly so that ACH Payment Activity by financial institutions would be covered by the HIPAA Rules. In fact, the HIPAA Rules' definition of the term "payment" is sufficiently broad to include ACH Payment

---

<sup>1</sup> Capitalized terms that are not defined in this memorandum are defined in the rules of the National Automated Clearing House Association.

\* Reprinted by permission of NACHA – The Electronic Payments Association

Activity. This broad definition of "payment" suggests that HHS should view ACH Payment Activity by a financial institution as outside the HIPAA Rules.

## **BACKGROUND**

The HIPAA Rules apply to "health care providers," "health care plans," and "health care clearinghouses." These "covered entities" are required to comply with standards for electronic transactions, privacy of medical records, and security of those records. Other organizations are not bound by the HIPAA Rules, although covered entities may be required to enter into business associate contracts in order to disclose protected health information ("PHI") lawfully to these non-covered organizations.<sup>2</sup> For RDFIs, the question is whether their activities bring them within the definition of "health care clearinghouse." The HIPAA Rules define the term "health care clearinghouse" to mean:

a public or private entity, including a billing service, repricing company, community health management information system, and "value-added" networks and switches, that does either of the following functions:

...

(2) Receives a standard transaction from another entity and processes or facilitates the processing of health information into nonstandard format or nonstandard data content for the receiving entity.<sup>3</sup>

The HIPAA Rules define the term "protected health information" to include individually identifiable health information.<sup>4</sup> "Health information" is defined broadly to include:

any information, whether oral or recorded in any form or medium, that:

(1) Is created or received by a health care provider, health plan, public health authority, employer, life insurer, school or university, or health care clearinghouse; and

(2) Relates to the past, present, or future physical or mental health or condition of an individual; the provision of health care to an individual; or the past, present, or future payment for the provision of health care to an individual.<sup>5</sup>

---

<sup>2</sup> See 45 C.F.R. § 164.504(e).

<sup>3</sup> 45 C.F.R. § 160.103.

<sup>4</sup> 45 C.F.R. § 164.501.

<sup>5</sup> *Id.*

# MORRISON & FOERSTER LLP

Privileged and Confidential \*

The HIPAA Rules generally permit the disclosure of PHI by a covered entity for payment purposes without the need for authorization by the individual.<sup>6</sup> The definition of "payment" in the HIPAA Rules is broad and includes, *inter alia*, the activities undertaken by a health plan to provide reimbursement for the provision of health care.<sup>7</sup> The supplementary information to the final HIPAA Rules notes that:

Covered entities may disclose protected health information for payment purposes to any other entity, regardless of whether it is a covered entity. For example, a health care provider may disclose protected health information to a financial institution in order to cash a check or to a health care clearinghouse to initiate electronic transactions.<sup>8</sup>

The amount of information in this disclosure by a covered entity is subject to a "minimum necessary standard."<sup>9</sup> Despite this limitation, in the supplementary information accompanying the HIPAA Rules, HHS states that the transmission of both electronic funds transfer ("EFT") information and electronic remittance advice ("ERA") information are payment activities.<sup>10</sup>

Section 1179 of HIPAA itself provides that:

To the extent that an entity is engaged in activities of a financial institution (as defined in section 1101 of the Right to Financial Privacy Act of 1978) or is engaged in authorizing, processing, clearing, settling, billing, transferring, reconciling, or collecting payments, for a financial institution, this part, and any standard adopted under this part, shall not apply to the entity with respect to such activities, including the following:

(1) The use or disclosure of information by the entity for authorizing, processing, clearing, settling, billing, transferring, reconciling or collecting, a payment for, or related to, health plan premiums or health care, where such payment is made by any means, including a credit, debit, or other payment card, an account, check, or electronic funds transfer.<sup>11</sup>

<sup>6</sup> See 45 C.F.R. § 164.502(a)(1)(iii). An exception exists in the definition requiring authorization before PHI can be disclosed with respect to psychotherapy notes. *Id.*

<sup>7</sup> 45 C.F.R. § 164.501. This definition of payment only applies in the HIPAA privacy rule in Section 164.

<sup>8</sup> 65 Fed. Reg. 82,462, 82,495 (Dec. 28, 2000).

<sup>9</sup> 45 C.F.R. §§ 164.502(b), 164.514(d)(4).

<sup>10</sup> 65 Fed. Reg. 82,462, 82,615, 82,616 (Dec. 28, 2000).

<sup>11</sup> 42 U.S.C. § 1320d-8. There is some debate over whether this exclusion for financial institutions applies to all authorized activities of financial institutions or merely to payment activities. See H.R. Rep. No. 104-736, at 268-269 (1996), "[t]he conferees do not intend to exclude the activities of financial institutions or their contractors from compliance with the standards adopted under this part [*i.e.*, the transactions rule and the privacy rule] if such activities would be subject to this part."

Finally, although the HIPAA Rules do not provide an express exclusion from the definition of "health care clearinghouse" for financial institutions, a statement in the supplementary information accompanying the HIPAA Rules indicates that HHS recognizes this exclusion, at least for payment purposes. In discussing the definition of a "business associate" in section 160.103 of the HIPAA Rules, HHS stated in the supplementary information that:

We do not consider a financial institution to be acting on behalf of a covered entity, and therefore no business associate contract is required, when it processes consumer-conducted financial transactions by debit, credit, or other payment card, clears checks, initiates or processes electronic funds transfers, or conducts any other activity that directly facilitates or effects the transfer of funds for compensation for health care.<sup>12</sup>

## **ANALYSIS**

Under the definitions of "protected health information" and "health care clearinghouse," an RDFI engaged in ACH Payment Activity could be construed to be a health care clearinghouse. For example, an RDFI might receive a credit ACH Entry for a Receiver who is a doctor or other health care provider sent by a patient's health insurer. The Entry could include information from both the EFT and ERA component of the ASC X12N 835 standard, thereby identifying the patient and the treatment for which the payment is being made. This information is PHI within the meaning of the HIPAA Rules. By receiving ERA information in a HIPAA standard format and converting the ERA information to the nonstandard format in which the doctor or healthcare provider ordinarily receives information about ACH Entries, the RDFI could be interpreted to be performing the functions of a health care clearinghouse within the definition of that term in the HIPAA Rules.<sup>13</sup>

However, a reading of the HIPAA Rules in their entirety strongly weighs against this interpretation. The structure of the HIPAA Rules is to regulate covered entities and the information they disclose to outside entities. It would be contrary to this structure to believe that HHS intended a financial institution to become a covered entity simply by processing payments delivered to the financial institution, directly or indirectly, by a covered entity. In addition, for HHS to regulate financial institutions due to their participation in payment activities would be contrary to section 1179. For instance, an

---

<sup>12</sup> 65 Fed. Reg. 82,462, 82,476 (Dec. 28, 2000). Although the first part of this statement refers to consumer-conducted financial transactions by debit, credit, or payment card, the references to clearing checks and processing electronic funds transfers are not limited to consumer-conducted transactions.

<sup>13</sup> The analysis in this memorandum applies to debit Entries as well as credit Entries. Depending on the format in which information about an Entry is provided to an RDFI's customer, there may be good arguments that the RDFI is not performing the function of a health care clearinghouse. For example, it may be argued that merely deleting a "wrapper" for the EFT or ERA component does not constitute processing the health information.

# MORRISON & FOERSTER LLP

Privileged and Confidential \*

Originating Depository Financial Institution ("ODFI") may receive information for payment purposes from a covered entity, and an RDFI may receive information for payment purposes from an ODFI. These organizations are entitled to assume that the covered entity is complying with the HIPAA Rules with respect to that information. The mere act of receiving and processing the information as described above, even where such information includes PHI, would not seem to transform the ODFI or the RDFI into a covered entity in the form of a health care clearinghouse.

This view is consistent with the statutory language in HIPAA creating the detailed section 1179 exclusion for payment activities. The view is confirmed by statements by HHS in the supplementary information to the HIPAA Rules. There is no evidence that HHS intended to include financial institutions that would ordinarily enjoy the section 1179 exclusion within the definition of a "health care clearinghouse" simply because they engage in ACH Payment Activity. For example, HHS does not purport to interpret section 1179 in defining health care clearinghouse to limit the types of payment activities that can be performed by financial institutions.<sup>14</sup> To the contrary, HHS itself states that payment activity as defined in the HIPAA privacy rule includes the transmission of both the EFT and the ERA components of the ASC X12N 835 standard.<sup>15</sup> Further, as noted above, HHS expressly recognized that contracts are not required when a financial institution processes electronic funds transfers or conducts any other activity that directly facilitates or effects the transfer of funds for compensation for health care.<sup>16</sup>

## CONCLUSION

For the reasons stated above, we believe that under the HIPAA Rules, a financial institution engaged in ACH Payment Activity should not be considered a health care clearinghouse and therefore should not be subject to HIPAA.

Oliver Ireland is a Partner at the law firm of Morrison & Foerster LLP. Mr. Ireland was formerly an Associate General Counsel at the Board of Governors of the Federal Reserve System with responsibilities for payment system issues.

Peter P. Swire is a Professor at the Moritz College of Law of the Ohio State University, and is a consultant to Morrison & Foerster LLP. From 1999 to early 2001, Mr. Swire served as the Chief Counselor for Privacy, U.S. Office of Management and Budget. In that role, he was the White House coordinator for the proposed and final HIPAA medical privacy rule, and he chaired the inter-agency process for defining "payment" in that rule.

---

<sup>14</sup> There is some doubt that an effort by HHS to limit the section 1179 exception would be effective under the standards established in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

<sup>15</sup> 65 Fed. Reg. 82,462, 82,616 (Dec. 28, 2002).

<sup>16</sup> See, *supra* note 12.







Attorneys at Law

Suite 900 607 14th St., NW  
Washington DC 20005-2018  
t 202 508 5800 f 202 508 5858  
www.KilpatrickStockton.com

April 29, 2003

direct dial 202 508 5802  
direct fax 202 585 0018  
MStember@KilpatrickStockton.com

To: Debra K. Stamper                      Cc: Tess Ferrera  
General Counsel, Kentucky  
Bankers Association

From: Mark L. Stember

Re: Lockbox Services under the HIPAA Privacy Rules

---

You have asked for guidance regarding whether the operation of a lockbox service for a physician by a Kentucky Bankers Association member bank (a "Bank") will subject a Bank to the business associate rules of the Standards for Privacy of Individually Identifiable Health Information (the "Privacy Rules").

#### **I. Factual Background**

Certain Banks operate what is commonly referred to as a "lockbox service" for its customers, some of whom are physicians. Although each Bank has slightly different procedures, generally, if a physician contracts with a Bank for a lockbox service, the physician will route all of the physician's payments for services to the lockbox that is established by the Bank. When the Bank receives these payments, typically through U.S. mail, the Bank will open the envelope, deposit the checks in the physician's account at the Bank and forward any correspondence in the envelope to the physician's office.

In general, a Bank receives payments from two different sources – patients and insurance companies / third-party administrators. If a Bank receives a payment from a patient, it deposits the check in the physician's account and forwards any other materials (e.g., copy of an invoice or a bill) in the envelope to the physician. If nothing is included with the check, the Bank may make a photocopy of the check or otherwise have some other type of system for informing the physician who made the payment. If a Bank receives a payment from an insurance company or third-party administrator, the check is usually for multiple patients and/or procedures. Therefore, in order for the physician to determine for which patients or procedures the check relates, the insurance company will send a copy of the various explanations of benefits ("EOBs") with the check. When the Bank receives this type of payment, it deposits the check in the physician's account and sends the EOBs to the physician. In either situation, patient or insurance company, the Bank has no reason to examine or retain any copies of invoices or EOBs that may be included with the payments in order to operate the lockbox. In all cases, the Bank simply

Memorandum to Debra K. Stamper  
April 29, 2003  
Page 2

forwards these materials directly to the physician without examination. In addition, the Banks do not maintain individualized patient or accounts receivable information as part of the operation of the lockbox. The lockbox services only entail the depositing of the checks in the physician's account. The physician or another entity unrelated to the Bank is responsible for adjusting and maintaining accounts receivable information.

## II. Privacy Rule Provisions and Analysis

Under the Privacy Rule, in general, a business associate is an entity that performs or assists in the performance of a function or activity involving the use or disclosure of protected health information ("PHI") for or on behalf of an entity covered by the Privacy Rules, such as a health care provider. 45 CFR § 160.103. Therefore, a Bank could be construed as a business associate of a physician for whom it operates a lockbox service, if the Bank is performing a covered service for the physician and such service involves the use or disclosure of PHI. If a Bank is treated as a business associate of a physician, the Bank would be required to enter into a business associate agreement with the physician and to meet certain other requirements as specified by the Privacy Rule. See, 45 CFR § 504(e).

In order to determine whether a Bank is performing a service for a physician that is covered by the Privacy Rules, we first need to examine two important statements made by HHS with respect to financial institutions.

HHS has stated that a physician or other covered entity may disclose PHI to a Bank in order to cash a check or initiate electronic transactions. This disclosure by itself would not mean that the Bank was a business associate. However, if a physician engaged another entity, such as a Bank, to conduct payment activities on its behalf, the Bank may meet the definition of a business associate under the Privacy Rule. The example given by HHS in this regard is when the entity, such as a Bank, is operating an accounts receivable system on behalf of the physician. See, 65 Fed. Reg. 82495 (December 28, 2000). Based upon your description of the lockbox services as summarized above, a Bank should not be operating an accounts receivable system of a physician. The main function of the lockbox service is to deposit the checks in the physician's account, while the physician or some other entity unrelated to the Bank adjusts the accounts receivable. (The other function of the lockbox service is to forward any materials to the physician that are included with the payments. This function is discussed below.) Therefore, based on this statement by HHS, the Banks should not be conducting "payment" activities on behalf of a physician because they are not operating an accounts receivable system on behalf of physicians.

In addition, HHS has stated that a Bank will not be acting on behalf of a physician when it "processes consumer-conducted financial transactions by debit, credit or other payment card, clears checks, initiates or processes electronic funds transfers, or conducts any other activity that directly facilitates or effects the transfer of funds for compensation for health care" (emphasis added). HHS indicates that in these cases "the identity of the consumer is always included and

Memorandum to Debra K. Stamper  
April 29, 2003  
Page 3

some health information (e.g., diagnosis or procedure) may be implied through the name of the health care provider being paid." Despite the presence of this potential PHI, the processing of those transactions does not rise to the level of a Bank being treated as a business associate under the Privacy Rules. See, 65 Fed. Reg. 82476 (December 28, 2000) and HHS FAQ, Page 43 (December 3, 2002).

While not entirely clear, based upon the emphasized language above, it is reasonable for a Bank to proceed under the position that the Bank is conducting an activity that directly facilitates or effects the transfer of funds for compensation for health care. While it is true that a Bank also receives PHI (such as EOBs and invoices) along with a payment transaction, if the Bank does not need or use this information in performing its services and it simply forwards this information to the physician without any use or disclosure of the PHI, it is reasonable to proceed without a business associate agreement.

In this regard, it is important to note that HHS does not consider janitorial services as giving rise to a business associate relationship. HHS has provided that janitors, while having access to PHI, do not need to use or disclose PHI in order to perform their services. Any use or disclosure of PHI that may occur during the performance of janitorial services is incidental and therefore exempt under the incidental provisions of the Privacy Rule. See, HHS FAQ Page 48 (December 3, 2002). Similarly, if the Banks do not need to use or disclose the PHI (such as the EOBs and invoices) in order to perform the lockbox services, the Banks should be able to take the same position as janitorial services under the HHS guidance. Therefore, if the Banks simply forward any PHI to the physician, similar to a janitor forwarding any trash containing PHI to the shredder or other disposal unit, any use or disclosure of the PHI would most likely be incidental to the normal banking services of the Bank and, as such, should be exempt from the Privacy Rule. See, 45 CFR § 160.502(a)(1)(iii). However, if a Bank does need to use the PHI that it receives, such as inspecting the EOB or invoice to determine the payee or amount of the check, then the Bank would most likely be treated as a business associate under the Privacy Rules.

Based upon the foregoing, if a Bank does not use or disclose the PHI that it may receive with a lockbox payment, but rather forwards it to the physician without examining it, it is reasonable for a Bank to continue to provide its lockbox services to a physician without treating itself as a business associate under the Privacy Rules.



***Financial Institutions' Acting as Business Associates:  
Self-Assessment Checklist  
for HIPAA Privacy for Healthcare Customers***

**Purpose:** This self-assessment tool is intended to provide financial institutions that offer services to health care providers and payors with a checklist of the privacy regulation requirements of the Health Insurance Portability and Accountability Act of 1996 (HIPAA). This checklist breaks down major aspects of the privacy regulations of HIPAA for a clearinghouse OR a business associate as defined in the HIPAA regulations. HIPAA citations are included in the checklist so you can reference the text of the regulations to get a better understanding of your responsibilities under HIPAA.

As a provider of financial services for health care providers and payors, you must first decide whether or not your organization will receive protected health information (PHI). If so, you need to further determine whether you will be functioning solely as a "business associate" OR as a "healthcare clearinghouse acting as a business associate" when you handle that PHI. This self-assessment has been developed with these two scenarios in mind. Businesses, including financial institutions, that will regularly have direct contact with individuals regarding their health-related diagnoses, treatments, or payments have additional responsibilities for notices, disclosures, and record keeping that are not addressed in this document.

The HIPAA Banking Task Force<sup>1</sup> has published two papers that may help you determine the appropriate classification of your organization under the HIPAA regulations. Morrison & Foerster, a respected Washington law firm with special expertise in the payments arena, has rendered an opinion that Receiving Depository Financial Institutions (RDFT's) engaged in payments processing as defined by HIPAA are not considered covered entities under the regulation.<sup>2</sup> At the time of this writing this interpretation has not been addressed by the Department of Health and Human Services (HHS). However, it does provide a framework on which a financial institution could evaluate its role with respect to the healthcare services it

---

<sup>1</sup> The HIPAA Banking Task Force was formed by NACHA, the Electronic Payments Association, and the American Bankers Association with support from the ANSI X12F Finance Committee, a number of individual financial institutions, Regional Payment Associations, healthcare industry experts, and America's Community Bankers. Membership is voluntary and is open to representatives of any interested financial institution or trade association representing the financial industry. Additional information is available at [www.hipaabanking.org](http://www.hipaabanking.org).

<sup>2</sup> Financial institutions engaged in activities that fall outside the boundaries of payment processing as defined by HIPAA may still be considered covered entities and should consult with legal counsel to determine actual status.

offers. A second document, *White Paper On HIPAA Related Issues Affecting The Banking Industry*, provides practical examples of processing arrangements in which financial institutions might be involved to provide further insight into the Morrison & Foerster interpretation. Both papers can be viewed or downloaded at [www.hipaabanking.org](http://www.hipaabanking.org). ***(Please note that any financial institution that handles PHI needs to recognize the privacy provisions of HIPAA even if the financial institution is not considered a clearinghouse under HIPAA.)***

**Disclaimer:** This self-assessment checklist has been developed by Ernst & Young LLP in conjunction with the members of the HIPAA Banking Task Force. This document is provided to your organization free of charge and is intended for your internal use only. Any reproduction of this document for commercial gain is strictly prohibited. This self-assessment checklist is based on the opinions of Ernst & Young LLP and the members of the HIPAA Banking Task Force and should not be construed as a legal opinion or legal guidance, and as such, Ernst & Young LLP and the HIPAA Banking Task Force do not accept any liability for your use of the thoughts and opinions expressed herein.

## ***What is HIPAA?***

The Health Insurance Portability and Accountability Act (HIPAA) of 1996 was enacted to achieve many goals. Besides setting standards to improve the efficiency for electronic data transmissions and processing, one of HIPAA's major goals is to make sure that sensitive, individually identifiable health information is protected and maintained in a secure manner when it is transmitted both inside and outside of the healthcare provider's organization. With respect to the privacy of an individual's health information, HIPAA applies to "covered entities" and their "business associates."

## ***What is a Covered Entity?***

A covered entity is a:

- Health care payor (i.e., insurance company);
- Health care provider who transmits information electronically using one of the standard HIPAA transactions<sup>3</sup> health care clearinghouse (see definition below),

## ***What is a Business Associate?***

A business associate is a person or company that, on behalf of a covered entity, performs or assists in the performance of a function or activity involving the use or disclosure of PHI. Because many types of healthcare transactions can contain PHI, financial institutions providing services like lockbox processing, ACH processing or information reporting to healthcare payors and providers need to determine whether PHI is being exchanged in a format that makes it visible to anyone (including an employee of the financial institution) other than the intended recipient. If so, the covered entity will likely require the financial institution to become a business associate. If PHI never flows through the financial institution or if it is processed in a manner that makes it recognizable only to the intended recipient and not the financial institution (like data encryption), a business associate relationship is not likely to be needed.

---

<sup>3</sup> The HIPAA standard transactions are defined in the HIPAA Transactions Rules (i.e., transactions using the ANSI X12N 4010 version for the (1) healthcare claims or equivalent encounter information, (2) healthcare payment and remittance advice, (3) coordination of benefits, (4) healthcare claim status, (5) enrollment and disenrollment in a health plan, (6) eligibility for a health plan, (7) health plan premium payments, (8) referral certification and authorization, (9) first report of injury, (10) health claims attachments and (11) other transactions that the Secretary may prescribe by regulation.



### ***What is a Health Care Clearinghouse?***

A health care clearinghouse is a public or private entity that either (1) processes (or facilitates the processing of) health information received from a covered entity in an electronic form to ensure that the data complies with HIPAA transaction standards, or (2) receives a HIPAA-compliant electronic transaction from another entity and processes (or facilitates the processing of) the health information into a human-readable or other non-HIPAA compliant format for the receiving entity.

### ***What is Protected Health Information?***

Protected Health Information (PHI) is *individual identifiable health information* that is maintained or transmitted either electronically or in any other form or medium. PHI may be used by covered entities and their business associates *solely* for purposes of treatment, payment or operations.

Health information includes (1) any information (oral, written, or electronic) (2) relating to an individual's past, present or future physical or mental health or condition OR to payment for health care; and (3) created or received by a healthcare provider, healthcare plan, public health authority, school, employer, life insurer or healthcare clearinghouse.

Identifiable information includes:

- Names;
- All geographic subdivisions smaller than a State, including street address, city, county, precinct, zip code, and their equivalent geocodes, except for the initial three digits of a zip code if, according to the current publicly available data from the Bureau of the Census:
  - (1) The geographic unit formed by combining all zip codes with the same three initial digits contains more than 20,000 people; and
  - (2) The initial three digits of a zip code for all such geographic units containing 20,000 or fewer people is changed to 000.

- All elements of dates (except year) for dates directly related to an individual, including birth date, admission date, discharge date, date of death; and all ages over 89 and all elements of dates (including year) indicative of such age, except that such ages and elements may be aggregated into a single category of age 90 or older;
- Telephone numbers;
- Fax numbers;
- Electronic mail addresses;
- Social security numbers;
- Medical record numbers;
- Health plan beneficiary numbers;
- Account numbers;
- Certificate/license numbers;
- Vehicle identifiers and serial numbers, including license plate numbers;
- Device identifiers and serial numbers;
- Web Universal Resource Locators (URLs);
- Internet Protocol (IP) address numbers;
- Biometric identifiers, including finger and voice prints;
- Full face photographic images and any comparable images; and
- Any other unique identifying number, characteristic, or code; such that the covered entity does not have actual knowledge that the information could be used alone or in combination with other information to identify an individual who is a subject of the information.

The HIPAA regulations are very clear that, with limited exceptions, PHI can only be exchanged with the covered entity responsible for that data and approved business associates. However, if the data is de-identified (i.e., the information related to the medical condition or payment can no longer be associated with a particular individual because the identifying information described above has been removed) then the underlying data can be used more broadly. *Given the complexities of de-identification and re-identification, Ernst & Young and the HIPAA Banking Task Force strongly recommend that financial institutions retain expert counsel before embarking on any program to use PHI outside of payment processing on behalf of covered entities and approved business associates.*

### **What is Treatment?**

Treatment is the provision, coordination or management of health care and related services by one or more health care providers.

### **What is Payment?**

Payment is obtaining premiums or determining coverage responsibilities with regard to:

- Eligibility determinations;
- Risk adjustment of payments;
- Billing
- Claims management;
- Medical review;
- Utilization review; or
- Pre-certification/pre-authorization.

The definition of "payment" in the HIPAA regulations at 12 C.F.R. § 164.501(1) includes: the "activities undertaken by: . . . (ii) A covered health care provider or health plan to obtain or provide reimbursement for the provision of health care." This specifically includes "Billing, claims management, collection activities . . ." 12 C.F.R. §164.501(2)(iii). Thus, the payment processing activities of financial institutions, including the delivery of remittance data in connection with health care claims payments, are clearly encompassed in the definition of "payment."

### **What are Health Care Operations?**

Health Care Operations, as defined by HIPAA are certain administrative, financial, legal, and quality improvement activities of a covered entity that are necessary to run its business and to support the core functions of treatment and payment. The definition of "health care operations" can be found at 45 CFR § 164.501.

### ***Coordination with Current Privacy Policies***

Although not necessarily required for a business associate or a clearinghouse acting as a business associate, the HIPAA Banking Task Force and Ernst & Young strongly recommend that financial institutions amend their existing privacy policies to reflect compliance with the privacy requirements of HIPAA. For example, most financial institutions will want to restrict the internal use and prohibit the use or distribution of healthcare related information to any parties other than the covered entities responsible for the data, any other business associates as authorized by the covered entities, and those disclosures to governmental and regulatory agencies as authorized under the regulation.

#	Question	HIPAA Regulation Reference <sup>4</sup>	Required * or Recommended		
				Yes	No
1.	Do you have staff dedicated to your institution's compliance responsibilities for medical privacy-related requirements?	§164.530a(1)	Recommended	<input type="checkbox"/>	<input type="checkbox"/>
2.	<p>Have all Business Associates with which you will exchange data been identified*? Will appropriate contract language be developed and inserted into the contracts governing your exchange and processing of data by April 14, 2003, except that the deadline is April 14, 2004 for:</p> <ul style="list-style-type: none"> <li>· contracts in existence as of October 15, 2002 that are not modified or renewed before April 14, 2003; or</li> <li>· contracts that automatically renew without changes in terms.</li> </ul> <p>*(This includes both contracts with covered entities and contracts you may have with third parties, such as temp personnel providers.)</p>	§164.502(d) §164.504(e)	Required	<input type="checkbox"/>	<input type="checkbox"/>

<sup>4</sup> Unless otherwise noted, all references to HIPAA regulations refer to volume 45 of the Code of Federal Regulations (e.g., 45CFR§164.530)

\*"Required," this applies to Business Associates and covered Entities. For all others, it is a recommendation.

#	Question	HIPAA Regulation Reference <sup>1</sup>	Required * or Recommended		
				Yes	No
3.	Have all your employees who have access to PHI been trained about your company's policies and procedures regarding PHI? Have you documented the successful completion of that training?	§164.530(b)	Recommended	<input type="checkbox"/>	<input type="checkbox"/>
4.	Have you implemented administrative, technical, and physical safeguards to protect privacy of PHI <u>while it is in your possession</u> ?	§164.530(c)	Recommended	<input type="checkbox"/>	<input type="checkbox"/>
5.	Have you amended your information security policies to reflect the safeguards required by HIPAA to protect the privacy of PHI <u>when sending or receiving data</u> ?	§164.530(c)	Recommended	<input type="checkbox"/>	<input type="checkbox"/>
6.	Does your organization's privacy policy cover PHI?	§164.530(i)	Recommended <sup>5</sup>	<input type="checkbox"/>	<input type="checkbox"/>
7.	Are policies and procedures in place to refer requests by individuals for PHI to the covered entity?	§164.502(g) §164.510(b) §164.514(h)	Required	<input type="checkbox"/>	<input type="checkbox"/>

<sup>5</sup> Although HIPAA does not require Healthcare Clearinghouses acting only as Business Associates to comply with this section of the privacy regulations, Ernst & Young recommends that organizations have appropriate policies and procedures in place for compliance. Healthcare Clearinghouses acting as Business Associates may be required to have these policies and procedures to achieve compliance with Business Associate contract language specified by the Covered Entity engaging that financial institution.

\*"Required," this applies to Business Associates and covered Entities. For all others, it is a recommendation.

#	Question	HIPAA Regulation Reference <sup>1</sup>	Required * or Recommended		
				Yes	No
8.	Do you have a process to track disclosures of PHI <u>other than for</u> payment, treatment and health care operations that are authorized by individuals so you can respond to pertinent requests by covered entities?	§164.528	Required	<input type="checkbox"/>	<input type="checkbox"/>
9.	Do you have policies and procedures to track uses and disclosures that do not require authorization by the individual (such as disclosures to law enforcement officials, health oversight agencies, etc.)?	§164.512	Required	<input type="checkbox"/>	<input type="checkbox"/>
10	Have you identified the minimum necessary PHI required for the use and disclosure of PHI and implemented policies and procedures consistent with the regulations?	§164.502(b) §164.514(d)	Required	<input type="checkbox"/>	<input type="checkbox"/>
11.	Does your Employee Manual or Code of Ethics cover violations involving the confidentiality of PHI, including the imposition of sanctions against a member of the workforce who is known to be in violation of those policies and procedures?	§164.530(e)	Recommended	<input type="checkbox"/>	<input type="checkbox"/>
12.	Is a process in place to mitigate, to the extent practical, any harmful effect of a violation of your policies and procedures?	§164.530(f)	Recommended	<input type="checkbox"/>	<input type="checkbox"/>
13.	Is there a procedure in place to allow covered entities to fulfill their requirements for access to PHI?	§164.524(a)(1)	Recommended	<input type="checkbox"/>	<input type="checkbox"/>

\* "Required," this applies to Business Associates and covered Entities. For all others, it is a recommendation.

Page 10

#	Question	HIPAA Regulation Reference <sup>4</sup>	Required * or Recommended		
				Yes	No
14.	Have you defined a policy and procedure for managing the requests of the covered entity's individual customers who ask for restrictions on the uses and disclosures of their PHI?	§164.502(c) §164.522(a)	Required	<input type="checkbox"/>	<input type="checkbox"/>
15.	Is a policy in place allowing the covered entity's individual customers to request an amendment to the PHI you have concerning them?	§164.526	Recommended	<input type="checkbox"/>	<input type="checkbox"/>
16.	Does your complaint process address complaints by the covered entity's individual customers about your policies and procedures about PHI?	§164.530(d)	Recommended	<input type="checkbox"/>	<input type="checkbox"/>

\*"Required," this applies to Business Associates and covered Entities. For all others, it is a recommendation.





**THE FAIR AND ACCURATE CREDIT  
TRANSACTION ACT OF 2003  
("FACT ACT")**

***Martha A. Ziskind  
PNC Bank, N.A.  
Louisville, Kentucky***

Copyright 2004. Martha A. Ziskind. All Rights Reserved.

**SECTION J**



**THE FAIR AND ACCURATE CREDIT  
TRANSACTION ACT OF 2003  
("FACT ACT")**

<b>INTRODUCTION .....</b>	<b>J-1</b>
<b>NEW NOTICE REQUIREMENTS .....</b>	<b>J-1</b>
1.    Affiliate Marketing Information Sharing Notice and Opt Out (New) .....	J-1
2.    Negative Information Reporting Notice (New) .....	J-2
3.    Risk-Based Pricing Notice (New) .....	J-3
4.    Home Loan Application Notice (New) .....	J-4
5.    FCRA Prescreen Notice (Revised) .....	J-5
<b>NEW DUTIES FOR USERS OF CREDIT REPORT INFORMATION .....</b>	<b>J-5</b>
1.    Fraud and Active Duty Alerts (FACT Act Section 112) .....	J-5
2.    Red Flag Guidelines .....	J-6
3.    Employee Investigations .....	J-6
4.    Address Discrepancies .....	J-7
<b>NEW DUTIES FOR FURNISHERS OF INFORMATION TO CRA'S .....</b>	<b>J-7</b>
<b>NEW DUTY TO FURNISH INFORMATION TO IDENTITY THEFT VICTIMS ....</b>	<b>J-8</b>
<b>NEW DUTIES FOR DEBT COLLECTORS WHERE IDENTITY THEFT IS ALLEGED .....</b>	<b>J-8</b>
<b>LIMITATION ON USE OF MEDICAL INFORMATION .....</b>	<b>J-8</b>
<b>MISCELLANEOUS PROVISIONS .....</b>	<b>J-9</b>
1.    Truncation of Debit and Credit Card Account Numbers .....	J-9
2.    Proper Disposal of Documents Containing Consumer Report Information and Other Records .....	J-9
3.    Change in Statutes of Limitations for FCRA .....	J-9
<b>ATTACHMENT I: Congressional Record - Extension of Remarks December 8, 2003, Pages E2512-E2519 .....</b>	<b>J-11</b>
<b>ATTACHMENT II: Regulatory Effective Dates for Various Provisions Of FACT Act .....</b>	<b>J-20</b>

**SECTION J**



## **The Fair and Accurate Credit Transaction Act of 2003 ("FACT Act")**

- **Introduction.**

On December 4, 2003, President Bush signed into law the Fair and Accurate Credit Transaction Act of 2003 (Pub. L. 109-159, 117 Stat. 1952, the "FACT Act"). The FACT Act brings together a number of industry and consumer legislative initiatives: (1) permanent extension of the federal preemptions contained in the Fair Credit Reporting Act ("FCRA") as amended in 1996 (15 U.S.C. 168 et seq.), most notably affiliate information sharing, prescreened credit offers, furnishers liability for reporting consumer information, and form of adverse action notice; (2) federal redress for victims of identity theft; (3) expanded obligations for all participants in the consumer credit information process: information furnishers, information users, and consumer reporting agencies ("CRA's"); and (4) protection of the privacy of medical information reported to or obtained from CRA's. Federal preemption is established for the FACT Act's nine identity theft provisions, for example, identity verification, CRA fraud alerts, red flag guidelines to help financial institutions recognize instances of identity theft, truncation of credit and debit card account numbers, and the blocking of information resulting from identity theft. There is NO federal preemption for state laws, such as those in California, governing display or use of social security numbers, alerts for data base intrusions, or penalties for identity theft. The multiple purposes of the FACT Act are discussed in the Conference Report on H.R. 2622, which is contained in Attachment #1.

While a few sections of the FACT Act have statutory effective dates, the effective dates of most provisions were established by regulations issued jointly by the Federal Reserve Board ("FRB") and the Federal Trade Commission ("FTC") on February 5, 2004. Unless otherwise specified in the FACT Act, March 31, 2004 is the effective date for provisions of the FACT Act that do not require significant changes to business procedures, and December 1, 2004 is the effective date for those provisions likely to entail significant changes to business procedures. A summary of the regulatory effective dates of FACT Act provisions is set out in Attachment 2. Statutory effective dates are noted in the text of this presentation, which will focus on those provisions of the FACT Act that will require action by financial institutions in the form of drafting and implementation of new procedures and employee training on the new procedures.

- **New Notice Requirements.**

The FACT Act creates four new notice requirements and one revised notice requirement, each with its own effective date.

1. *Affiliate Marketing Information Sharing Notice and Opt Out (New)*

Section 214 of the FACT Act adds yet a third information sharing notice and opt-out to the notices and opt-outs already required by the FCRA and Title V of the Gramm-Leach-Bliley Act (Pub. L. 106-102, "GLB"). This new notice is in effect the quid pro quo for the permanent federal preemption for financial institution affiliate information sharing.

Recall that Section 603(d)(2)(A)(ii) of the FCRA permits affiliated institutions to share without notice customer identification, transaction and experience information, for example, name, address, social security number, account balances, and loan payment histories. Section 603(d)(2)(A)(iii) requires customer notice and opt-out if the financial institution wishes to share "other" information, such as application data, financial statements, or credit scores. FCRA Section 624(b)(2) created a federal preemption for affiliate information-sharing, which was reauthorized and made permanent by the FACT Act. Title V of the GLB Act requires a notice and opt-out before a financial institution shares any information with an unaffiliated third party unless the disclosure is made pursuant to one of the GLB exceptions, for example, to process a transaction, sale of accounts, subpoena, or other legal process, reports to credit reporting agencies, or with customer consent. Both notices and opt-outs are contained in the consumer privacy disclosures made by financial institutions when accounts are established and annually thereafter.

The FACT Act creates a new affiliate sharing notice if any information, for example, transaction, experience, or application information, will be shared with an affiliate for marketing purposes. This new notice must be "clear, conspicuous and concise," and a consumer's opt-out choice must be honored for five years. After five years, the financial institutions must send another notice and opt-out if it wants to send marketing solicitations. The affiliate marketing notice and opt-out is not required if the consumer has a preexisting business relationship with both affiliates. Other notice exceptions include transfers to (i) facilitate communications relating to an employee benefit plan; (ii) permit one affiliate to perform services for another affiliate; (iii) respond to a communication initiated by a consumer; (iv) respond to solicitations authorized by the consumer; or (v) comply with state insurance law anti-discrimination provisions.

Regulations implementing the marketing notice and opt-out requirements are due by September 4, 2004, with an effective date six months after the regulations are issued. Information acquired prior to the regulatory effective date may be shared without the marketing notice and opt-out. The challenge to financial institutions will be to add this new notice to their privacy statements without totally confusing their customers.

## *2. Negative Information Reporting Notice (New)*

Section 217 of the FACT Act requires creditors who report negative information (i.e. delinquencies or charge-offs) to nationwide CRA's to provide notice to the affected consumer before or no later than 30 days after such information is reported. The

notice need be provided only once but may not be included with the initial Truth-in-Lending disclosure. The notice may, however, be included in a default notice, on a billing statement or in the institution's GLB privacy disclosure. The regulators must develop a model form of no more than 30 words by June 2004, and financial institutions must begin providing the notice no later than December 1, 2004. Using the model form will provide a "safe harbor."

After providing the notice, the financial institution may submit additional information about the same account without providing another notice. A financial institution will not be liable for failure to provide the notice if it maintains reasonable compliance policies and procedures or the financial institution reasonably believes it is prohibited by law from contacting the customer.

### 3. *Risk-based Pricing Notice (New)*

Section 615 of the FCRA requires credit report users who take "adverse action" on the basis of credit report information to send an "adverse action" notice that identifies the CRA that provided the information.

Section 311 of the FACT Act requires lenders that use "risk-based" pricing underwriting programs based in whole or in part on credit report information to provide a notice to applicants when credit report information could cause "material" credit terms to be "materially less favorable than the most favorable terms available to a substantial portion" of the lender's new customers. The notice may be oral, written or electronic. This notice is required, for example, where the consumer accepts a counter offer with less favorable terms because of credit report information. It would not be required where a financial institution sends the standard FCRA adverse action letter. The notice would also not apply to a prescreened offer unless the lender changes the terms after the consumer responds to the prescreened offer. The FRB and FTC are to prescribe regulations concerning the form, content, time and manner of delivery of notice, as well as a model form. The notice must at a minimum:

- include a statement informing the consumer that the offered terms are based on information from a consumer report;
- identify the CRA that furnished the report;
- tell the consumer that the consumer may obtain a copy of the consumer report without charge from the CRA; and
- include contact information for the CRA (including a toll free telephone number for nationwide CRA's).

The regulations will define "material" and materially less favorable."

Unless the regulations provide otherwise, the notice may be provided at time of application or credit approval. This notice requirement becomes effective on December 1, 2004.



#### 4. *Home Loan Application Notice (New)*

Section 212(g) of the FACT Act requires lenders to provide to applicants for consumer open or closed end loans secured by one to four units of real property a copy of their credit score(s) and a new notice telling the applicant that the lender must disclose the credit score(s) used in connection with the home loan application and the key factors affecting the credit scores.

The notice must include the name, address and telephone number of each CRA that provided a credit score used in connection with the application. The text of the notice as provided in the FACT Act is as follows:

#### NOTICE TO THE HOME LOAN APPLICANT

In connection with your application for a home loan, the lender must disclose to you the score that a consumer reporting agency distributed to users and the lender used in connection with your home loan, and the key factors affecting your credit scores.

The credit score is a computer generated summary calculated at the time of the request and based on information that a consumer reporting agency or lender has on file. The scores are based on data about your credit history and payment patterns. Credit scores are important because they are used to assist the lender in determining whether you will obtain a loan. They may also be used to determine what interest rate you may be offered on the mortgage. Credit scores can change over time, depending on your conduct, how your credit history and payment patterns change, and how credit scoring technologies change.

Because the score is based on information in your credit history, it is very important that you review the credit-related information that is being furnished to make sure it is accurate. Credit records may vary from one company to another.

If you have any questions about your credit score or the credit information that is furnished to you, contact the consumer reporting agency at the address and telephone number provided with this notice, or contact the lender, if the lender developed or generated the credit score. The consumer reporting agency plays no part in the decision to take any action on the loan application and is unable to provide you with specific reasons for the decision on a loan application.

If you have any questions concerning the terms of the loan, contact the lender.

The lender is not obligated to explain the credit score or to assume any liability for the content of the notice. If the lender uses an automated underwriting system, the lender may disclose the credit score and associated key facts provided by a CRA. If the lender uses the Fannie Mae or Freddie Mac automated underwriting systems, the lender must disclose the score disclosed to the lender by the system. Only one disclosure is required per transaction. No disclosure is required for credit scores obtained after loan closing. This requirement preempts state laws except for selected provisions of law in California, Colorado, Georgia, Maine, Maryland, New Jersey, and Vermont.

Any provision in a contract between a lender and a CRA that prohibits disclosure of a credit score is rendered void by the FACT Act.

The regulators will establish both the form and the effective date of the new notice.

#### *5. FCRA Prescreen Notice (Revised)*

Section 213 of the FACT Act requires the FTC and the financial institution regulators to issue a revised format for the notice contained in prescreened credit offers no later than December 4, 2004.

The revised notice is to be "in such format and in such type size and manner as to be simple and easy to understand." The prescreen opt-out will be effective for five rather than two years. The FTC is to publicize the CRA opt-out addresses and telephone numbers on its website, and the FRB is to study and report on the prescreen opt-out process with a recommendation as to whether further statutory limitation on prescreened offers is required.

#### **• New Duties for Users of Credit Report Information.**

The FACT Act recognizes that lenders have a significant role to play in limiting the effects of identity theft and imposes new duties on lenders who use CRA information.

##### *1. Fraud and Active Duty Alerts (FACT Act Section 112)*

If a consumer suspects that he/she may be the victim of identity theft, the consumer may notify a CRA, and the CRA must place an "initial" fraud alert on the consumer's file. The "initial" fraud alert is good for 90 days. A consumer serving in the military may require a CRA to place an "active duty" alert on his/her file. The "active duty" alert lasts 12 months.

If a consumer's credit report contains an "initial" fraud alert or "active duty" alert, the lender must contact the consumer at the telephone number provided by the consumer and shown in the alert or take other reasonable steps to confirm the consumer's identity. Once the consumer files a fraud report with a law enforcement agency, the alert becomes an "extended" alert. "Extended" alerts are good for seven years. If a lender receives a credit report that contains an "extended alert," the lender must contact the consumer by phone or other method designated by the consumer to confirm that the credit application is not the result of identity theft. CRA's are required to exclude consumer files with "extended" fraud alerts from prescreened lists for five years. Credit files with "active duty" alerts must be excluded from prescreen lists for two years. The FTC will prescribe regulations to implement the fraud and active duty alert requirements, which will be effective by December of 2004. Financial institution credit underwriters must become familiar with the significance of the fraud and active duty alerts.

The consumer need contact only one CRA. The contacted CRA is then responsible for notifying other national CRA's.

## *2. Red Flag Guidelines*

Section 114 of the FACT Act requires the regulatory agencies to establish "red flags," whose presence should alert financial institutions to possible identity theft. The red flag customer identification requirements are to be consistent with Patriot Act requirements. A specific red flag identified in the FACT Act is the receipt by a debit or credit card issuer of a request for a new or replacement card within 30 days after an address change on the account. The card issuer must either notify the cardholder at the cardholder's former address or use other means to assess the validity of the address change. The red flag regulations must also contain reasonable guidelines for dealing with transactions on credit or deposit accounts that have been inactive for more than 2 years. The regulations are to become effective on December 1, 2004.

## *3. Employee Investigations*

The FCRA as amended in 1996 established an elaborate consent and notification process when employer or prospective employers use consumer reports for employment purposes. Section 611 of the FACT Act eliminates the consent requirement when a third party is retained in connection with an investigation involving job misconduct, compliance with federal, state or local laws or the rules of self-regulatory organizations (e.g., NASD), or preexisting written policies of the employer. Results of the investigation may be communicated only to the employer, federal, state, or local officers, to self-regulatory organization, or as otherwise required by law.

The employee must still receive an adverse action notice, but the source(s) of information that resulted in the adverse action need not be identified. Section 611

responds to a 1999 FTC opinion that held that the third party investigator could be a CRA for FCRA purposes.

#### 4. *Address Discrepancies*

Section 315 of the FACT Act directs the FTC and the federal financial institution regulatory agencies to establish guidance on "reasonable policies and procedures" to be followed by a user of a consumer report when the user is notified by a CRA that the address of consumer supplied by the user is substantially different from the address in the consumer's file maintained by the CRA. These procedures are to become effective on December 1, 2004.

#### • **New Duties for Furnishers of Information to CRA's**

1. Section 154(a) of the FACT Act provides that a furnisher of information to a CRA must have reasonable procedures to respond to a notice from the CRA that the information it has provided is the result of identity theft. Such procedures must include procedures to prevent refurnishing of such information.
2. Section 154(a) also requires information furnishers to have procedures to block information arising from a purported identity theft when the identity theft report is submitted by the alleged victim. Financial institutions may specify an address for submission of such reports.
3. To further limit the spread of information arising from an alleged identity theft, Section 154(b) provides that except in the case of repurchase, securitization, or transfer as a result of merger or acquisition, a creditor may not sell, transfer for consideration or place for collection a debt after the creditor has been notified that the debt is the result of identity theft.
4. Section 312(a) of the FACT Act requires the FTC and the financial institution regulators to establish and maintain guidelines for use by information furnishers with respect to the accuracy and integrity of information furnished to CRA's. The regulators are to consider, among other factors: (1) patterns, practices, and activity that can compromise the accuracy and integrity of such information; (2) the methods used to furnish information; (3) policies and procedures currently in place; and (4) procedures for investigating complaints.
5. Section 312(b) of the Fact Act modifies the FRCA Section 623(a)(1)(A) information accuracy standard for furnishers of information by replacing the current standard "knows or consciously avoids knowing that the information is accurate" with "knows or has reasonable cause to believe that the information is accurate."

6. Section 312(b) also requires the FTC and the federal financial institution regulators to identify the circumstances when a furnisher is required to reinvestigate a disputed report to a CRA if the reinvestigation request is made directly by the consumer. Section 312(e) details the procedures to be followed both by the consumer disputing information supplied to a CRA and by the furnisher of that information.

- **New Duty to Furnish Information to Identity Theft Victims.**

In order for identity theft victims to document fraudulent transactions, Section 151(e) of the FACT Act provides that any business entity that has provided credit, goods, or services to an alleged identity thief must, within 30 days of a victim's request, provide a copy of the account application and transaction records to the victim and to a law enforcement agency or officer specified by the victim. The alleged victim must provide identification information, a copy of the police report and a standard identity theft affidavit (to be developed by the FTC) or other acceptable affidavit of fact. The business entity may specify an address for receipt of this document and may request additional information to support the claim of identity theft, but it may not charge for providing the requested documentation. A business may decline to provide the information if, for example, it does not have a high degree of confidence that it knows the true identity of the person requesting the information or the request is based on a misrepresentation of fact. A business entity that in good faith furnishes information to an alleged victim may not be held liable for such disclosure.

This provision will become effective in early June 2004 (180 days after December 4, 2003.) Financial institutions will need to designate an area for receipt of these record requests and develop procedures to document and comply with these requests.

- **New Duties for Debt Collectors Where Identity Theft is Alleged.**

Section 155 of the FACT Act provides that debt collectors must notify the creditor if the debt collector is advised that the debt may be the result of identity theft.

This requirement takes effect on December 1, 2004.

- **Limitation on Use of Medical Information.**

Title IV of the FACT Act (Sections 411 and 412) limits the use of medical information<sup>1</sup> that reaches the financial system. The consumer's written consent is required before a

---

<sup>1</sup> "Medical Information" under the FACT Act means "information or data, whether oral or recorded, in any form or medium, created by or derived from a health care provider or the consumer that relates to: (A) the past, present, or behavioral health or condition of an individual; (B) the provision of health care to an individual; or (C) payment for the provision of health care to an individual."

CRA may furnish medical information for employment, insurance or credit purposes. An insurer who receives medical information may use and disclose it only for insurance purposes. A creditor may not obtain or use a consumer's medical information to determine credit eligibility except as permitted under regulations by the federal bank regulatory agencies for operations, transactional and other necessary and appropriate reasons. Regulations are to be finalized by June 2004. Medical information, as defined by the FACT Act, which includes lists of identified consumers based on their payment transactions for medical products or services, may not be shared among affiliates unless the information is provided for the purchase of an annuity or insurance, and in accordance with HIPAA, or as otherwise permitted by regulations.

- **Miscellaneous Provisions.**

1. *Truncation of Debit and Credit Card Account Numbers.*

Section 113 of the FACT Act provides that machines that print debit or credit card receipts must truncate all but the last five digits of the card number as well as the card expiration date. For machines put into use before January 1, 2005, the effective date is three years after enactment, that is, December 4, 2005. Machines installed after January 1, 2005, must comply immediately.

2. *Proper Disposal of Documents Containing Consumer Report Information and Other Records*

Section 216 of the FACT Act provides that by December, 2004, the financial institution regulators are to issue final regulations, consistent with GLB, requiring any entity that maintains or possesses consumer information, or compilations of consumer information derived from credit reports to properly dispose of the information.

3. *Change in Statutes of Limitations for FCRA*

Section 156 of the FACT Act increases the time period for claims that the FCRA has been violated. Effective March 31, 2004, the consumer has the earlier of two years after discovery or five years after the violation to bring suit. Private rights of action are not available for violations of Section 623(a) of the FCRA as revised except where a state official brings an action on behalf of state residents after a furnisher has violated an injunction. Similarly there are no private rights of action for violation of furnisher accuracy provisions (FACT Act Section 312) or for the "red flag" provisions.



## **ATTACHMENT I**

(See "Congressional Record - Extension of Remarks"

December 8, 2003, Pages E2512-E2519)



Division 1 championship game record 252 rushing yards—spearheaded the offense, while Elder's swarming defense held opposing teams to just seven points in four of the five playoff games. And, as always, thousands of Elder faithful traveled across the state braving the cold to support the Panthers throughout the playoffs.

The hard work and sacrifice of the young men at Elder have brought pride and honor to Price Hill and our entire community. Football fans throughout the Cincinnati area congratulate the Panthers on their back-to-back championships and share in their celebration.

Mr. Speaker, to appropriately honor these young men and coaches, I'd like to submit for the RECORD the roster of the 2003 Elder Panthers and a copy of their schedule and game results.

ELDER HIGH SCHOOL, 2003 OHIO HIGH SCHOOL STATE FOOTBALL CHAMPIONS, FINAL RECORD: 14-1

#### REGULAR SEASON

Game 1: August 21, 2003, Elder 33- Winton Woods 14

Game 2: August 30, 2003, Indianapolis Warren Central 45- Elder 20

Game 3: September 5, 2003, Elder 50- Western Hills 8

Game 4: September 12, 2003, Elder 17- Indianapolis Bishop Chatard 16

Game 5: September 19, 2003, Elder 42- LaSalle 7

Game 6: September 26, 2003, Elder 49- Covington Catholic 21

Game 7: October 3, 2003, Elder 21- Moeller 20

Game 8: October 10, 2003, Elder 28- St. Xavier 7

Game 9: October 17, 2003, Elder 21- Indianapolis Cathedral 7

Game 10: October 24, 2003, Elder 24- Oak Hills 21

#### PLAYOFFS

Round 1: November 1, 2003, Elder 28- Anderson 7

Round 2: November 8, 2003, Elder 33- Clayton Northmont 7

Regional Championship: November 15, 2003, Elder 24- Colerain 23

State Semi-Final: November 22, 2003, Elder 31- Dublin Scioto 7

State Championship: November 29, 2003, Elder 31- Lakewood St. Edward 7

#### 2003 ELDER PANTHERS VARSITY FOOTBALL ROSTER

##### HEAD COACH

Doug Ramsey.

##### ASSISTANT COACHES

Ken Lanzillotta; Ray Heidorn; Mike Kraemer; Craig James; Tim Schira; Matt Eisele; and Pat Good.

##### SENIORS

No. 34 Eric Andriacco; No. 54 Steve Baum; No. 58 Kenny Berling; No. 26 Ryan Brinck; No. 20 Michael Brown; No. 50 Dave Bullock; No. 68 Alec Burkhardt; No. 23 Mark Byrne; No. 5 Charlie Coffaro; No. 71 Justin Crone; No. 29 Brett Currin; No. 12 Rob Florian; No. 84 Kurt Gindling; No. 11 Bradley Glatthaar; No. 99 Alex Harbin.

No. 97 Steve Haverkos; No. 70 Chris Heaton; No. 82 Nick Klaserner; No. 7 Dan Kraft; No. 48 Joe Lind; No. 47 Pat Lysaght; No. 53 Corey McKenna; No. 60 Mike Meese; No. 92 Tim Mercurio; No. 30 Drew Metz; No. 72 Mark Naltner; No. 28 Alex Niehaus; No. 21 Billy Phelan; No. 31 Seth Priestle.

No. 65 Nick Rellar; No. 2 Jake Richmond; No. 91 Tony Stegeman; No. 88 Ian Steidel; No. 9 Mike Stoecklin; No. 45 Tim Teague; No. 24 John Tiemeier; No. 90 Matt Umberg; No. 10 Jeff Vogel; No. 16 Eric

Welch; No. 74 John Wellbrock; No. 87 Mike Windt; No. 75 Eric Wood; and No. 94 Mike Zielasko.

#### JUNIORS

No. 52 Steve Aneviski; No. 6 Brian Bailey; No. 41 Guy Beck; No. 18 Matt Bengel; No. 57 Nick Berning; No. 38 Joe Broerman; No. 13 Craig Carey; No. 89 Kevin Crowley; No. 14 Andrew Curtis; No. 95 Andrew Dinkelacker; No. 76 Alex Duwel; No. 33 Tim Dwyer; No. 66 Phil Ernst; No. 37 Eric Harrison; No. 36 Alex Havlin; No. 78 Josh Hubert.

No. 39 D.J. Hueneman; No. 15 R.J. Jameson; No. 43 Reid Jordan; No. 96 Eric Kenkel; No. 44 Bradley Kenny; No. 51 Chris Koopman; No. 42 Nick Kuchey; No. 67 Mark Menninger; No. 69 John Meyer; No. 32 Robert Nusekabel; No. 22 Billy O'Conner; No. 8 Mike Priore; No. 17 Andrew Putz; No. 46 Zack Qunell; No. 77 Brandon Rainier.

No. 3 Jeremy Richmond; No. 93 Jake Rieth; No. 73 Scott Roth; No. 19 Parker Smith; No. 98 Jared Sommerkamp; No. 86 Louis Sprague; No. 27 Rickey Stautberg; No. 79 Ben Studdt; No. 62 Joe Super; No. 1 Pat Van Offen; No. 61 Kurt Weil; No. 25 J.T. Westerfield; No. 40 Ben Widolff; No. 4 Nick Williams; and No. 81 Ben Wittwer.

#### SOPHOMORES

No. 35 Adam Baum and No. 49 Gerald Walker.

#### MANAGERS

T.J. Weil and Andy Brunzman.

### TRIBUTE TO CORPORAL SEBASTIAN DEGAETANO

### HON. GINNY BROWN-WAITE

#### OF FLORIDA

#### IN THE HOUSE OF REPRESENTATIVES

Monday, December 8, 2003

Mr. GINNY BROWN-WAITE of Florida. Mr. Speaker, I rise today to honor CPL Sebastian Degaetano, a veteran of the second world war and a resident of Port Richey, Florida in my Fifth Congressional District.

I will soon have the pleasure of recognizing CPL. Sebastian Degaetano for his heroism and bravery as a U.S. soldier who fought in the European Theater from January 19, 1943 through March 28, 1946.

During the pivotal Battle of the Bulge, which turned the tide against the Germans and was the largest land battle of World War II, CPL Degaetano was hit in his leg by shrapnel.

I will present CPL Sebastian Degaetano with the Purple Heart, the oldest military decoration in the world, nearly 50 years overdue.

Though he earned this honor, he never received it from the Defense Department and I am honored to have the opportunity to present to him the Purple Heart for his selfless devotion to duty and service to the United States.

### CONFERENCE REPORT ON H.R. 2622, FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003

#### SPEECH OF

### HON. MICHAEL G. OXLEY

#### OF OHIO

#### IN THE HOUSE OF REPRESENTATIVES

Friday, November 21, 2003

Mr. OXLEY. Mr. Speaker, I rise today to express my appreciation for the work Congress

has done to pass H.R. 2622, the Fair and Accurate Credit Transactions Act of 2003. H.R. 2622 includes numerous consumer protection measures designed to combat the growing crime of identity theft and to improve the accuracy of the credit reporting system. This landmark legislation will also ensure the continued vibrancy of our national credit markets.

Given the complexity of H.R. 2622, it is both appropriate and important to submit for the record a section-by-section summary of the legislation in order to help provide an understanding of the legislation and its impact on the Fair Credit Reporting Act.

The legislation provides significant measures to help consumers, financial institutions and consumer reporting agencies prevent and mitigate identity theft. For example, the legislation establishes requirements for the placement of fraud alerts on consumer credit files, investigation of changes of address, truncation of credit card and debit card account numbers on receipts, and the manner in which information identified as having resulted from identity theft is blocked.

In addition, the legislation establishes requirements for verifying the accuracy of consumer information and preventing the reporting of consumer information that results from identity theft. Financial institutions must also take certain steps before establishing new loans and credit accounts for consumers who have fraud alerts on their credit files.

Lastly, the legislation includes provisions entitling consumers to obtain free credit reports and access to their credit scores. This provision will likely do more for financial literacy and consumer education than any legislation in decades.

I am submitting this section-by-section analysis on behalf of myself and the gentleman from Alabama (Mr. BACHUS), the Chairman of the Financial Institutions and Consumer Credit Subcommittee, who introduced H.R. 2622 and presided over a series of hearings over the past year that laid the groundwork for this landmark legislation.

#### SECTION BY SECTION ANALYSIS OF THE LEGISLATION

##### Section 1. Short title; table of contents

This section establishes the short title of the bill, the "Fair and Accurate Credit Transactions Act of 2003" (the FACT Act).

##### Section 2. Definitions

This section adds a number of definitions for use in provisions of the Act that are not amendments to the Fair Credit Reporting Act.

##### Section 3. Effective dates

This section specifies effective dates for the legislation. Several sections are given specific effective dates. For sections adding new provisions or standards where no effective date is provided, this section provides a general rule providing for the Federal Reserve Board (the Board) and the Federal Trade Commission (FTC) within 2 months to jointly determine the appropriate effective dates for the remaining provisions, not to exceed 10 months from making their determination.

#### TITLE I- IDENTITY THEFT PREVENTION AND CREDIT HISTORY RESTORATION

##### Subtitle A- Identity Theft Prevention

##### Section 111. Amendment to definitions

This section includes a number of definitions, including definitions for fraud alerts, identity theft reports, financial institutions, and nationwide specialty consumer reporting agency.

*Section 112. Fraud alerts and active duty alerts*

The section sets forth a uniform national consumer protection standard for the processing of credit and verification procedures where there is an elevated risk of identity theft. The section allows certain identity theft victims and active duty military consumers to direct nationwide consumer reporting agencies to include a fraud alert or active duty alert in each consumer report furnished on them that can be viewed by creditors and other users of the report in a clear and conspicuous manner. Upon receiving proof of the consumer's identity and the consumer's request for an alert, the agency must place the alert in the consumer's file for a certain time period (or such other time agreed to upon the request or subsequently) in a manner facilitating its clear and conspicuous viewing, inform the consumer of the right to request free credit reports within 12 months, provide the consumer with the disclosures required under section 609 within 3 business days of requesting the disclosures, and refer the necessary information related to the alert to the other nationwide credit reporting agencies. The request must be made directly by the consumer or by an individual acting on their behalf or as their representative. This limitation on the request is intended to allow a consumer's family or guardian to request an alert for the consumer where appropriate, while preventing credit repair clinics and similar businesses from making such requests. Resellers of credit reports must reconvey any alert they receive from a consumer reporting agency. Agencies other than those described in section 603(p) must communicate to the consumer how to contact the Commission and the appropriate agencies.

The national standard creates 3 types of alerts. A consumer with a good faith suspicion that he or she has been or is about to be a victim of identity theft or other fraud may request an initial alert. The initial alert must be placed in the consumer's file for 90 days and the consumer may request one free credit report within 12 months. If the consumer has an appropriate identity theft report (typically a police report) alleging that a transaction was the result of fraud by another person using the consumer's identity, then the consumer may alternatively request an extended alert. The agency must place the extended alert in the consumer's file for 7 years, inform the consumer of the right to 2 free credit reports within 12 months, exclude the consumer's name from lists used to make prescreened offers of credit or insurance for 5 years, and include in the file the consumer's telephone number (or another reasonable contact method designated by the consumer). An active duty member of the military may alternatively request an active duty alert, which does not imply the immediate threat of identity theft, but as a preventative measure, a nationwide consumer reporting agency must respond to such a request by placing an active duty alert in the member's file for one year and exclude the member from lists used to make prescreened offers of credit or insurance for 2 years.

Users of consumer reports that contain an alert cannot establish a new credit plan or provide certain other types of credit in the name of a consumer, issue additional cards at the request of a consumer on an existing credit account, or grant an increase in a credit limit requested by the consumer on an existing credit account, without utilizing reasonable policies and procedures to form a reasonable belief of the requester's identity. In the case of an initial or active duty alert, if the requester has specified a telephone number to be used for identity verification,

then the user may contact the consumer using that number or must take other reasonable steps to verify the requester's identity and confirm that the request is not the result of identity theft. In the case of an extended alert, the user may not grant the request unless the consumer is contacted either in person (such as in a bank branch or retail store location), by telephone, or through any another reasonable method provided by the consumer, to confirm that the request is not the result of identity theft.

*Section 113. Truncation of credit card and debit card account numbers*

This section creates a uniform national standard requiring businesses that accept credit or debit cards to truncate the card account numbers (printing no more than the last 5 digits) and exclude card expiration dates on any electronically printed receipts. This requirement becomes effective 3 years after enactment for any cash registers in use on or before January 1, 2005 and 1 year after enactment for any register put into use after January 1, 2005. The requirement does not apply to transactions in which the sole means of recording the person's credit card or debit card number is by handwriting or by an imprint or copy of the card.

*Section 114. Establishment of procedures for the identification of possible instances of identity theft*

This section directs the Federal banking agencies, the National Credit Union Administration (NCUA), and FTC to jointly formulate various red flag guidelines to help financial institutions and creditors identify patterns, practices and specific forms of activity that indicate the possible existence of identity theft. These agencies also must prescribe regulations creating uniform national standards for the entities they supervise requiring the entities to establish and adhere to reasonable policies and procedures for implementing the guidelines. The policies and procedures established under this section are not to be inconsistent with the policies and procedures required by section 326 of the USA PATRIOT Act, particularly with respect to the identification of new and prospective customers. In issuing regulations and guidelines under this Act, the Federal agencies are expected to take into account the limited personnel and resources available to smaller institutions and craft such regulations and guidelines in a manner that does not unduly burden these smaller institutions.

The red flag regulations shall include requiring issuers of credit cards and debit cards who receive a consumer request for an additional or replacement card for an existing account within a short period of time after receiving notification of a change of address for the same account to follow reasonable policies and procedures to ensure that the additional or replacement card is not issued to an identity thief. Specifically, before issuing a new or replacement card the issuer must either notify the cardholder of the request at the cardholder's former address and provide a means of promptly reporting an incorrect address change; notify the cardholder of the request in a manner that the card issuer and the cardholder previously agreed to; or otherwise assess the validity of the cardholder's change of address in accordance with reasonable policies and procedures established by the card issuer pursuant to the "red flag" guidelines applicable to the card issuer.

The Federal banking agencies, the NCUA and the FTC also are directed to consider whether to include in the red flag guidelines instructions for institutions to follow when a transaction occurs on a credit or deposit account that has been inactive for more than 2

years in order to reduce the likelihood of identity theft.

*Section 115. Authority to truncate social security numbers*

This section allows consumers, upon providing appropriate proof of identity, to demand that a consumer reporting agency truncate the first 5 digits of the consumer's social security or other identification number on a consumer report that the consumer is requesting to receive pursuant to section 609(a) of the FCRA.

*Subtitle B- Protection and Restoration of Identity Theft Victim Credit History**Section 151. Summary of rights of identity theft victims*

This section requires the FTC, in consultation with the banking agencies and the NCUA, to prepare a model summary of the rights of consumers to help them remedy the effects of fraud or identity theft. Consumer reporting agencies must provide any consumer contacting them expressing the belief of identity theft victimization with a summary of rights containing the information in the FTC's model summary and the FTC's contact information for more details. The section also requires the FTC to develop and implement a media campaign to provide more information to the public on ways to prevent identity theft. It is important for the agencies to let consumers know that identity thieves target home computers because they contain a goldmine of personal financial information about individuals. In educating the public about how to avoid becoming a victim of identity theft, the FTC and the federal banking regulators should inform consumers about the risks associated with having an 'always on' Internet connection not secured by a firewall, not protecting against viruses or other malicious codes, using peer-to-peer file trading software that might expose diverse contents of their hard drives without their knowledge, or failing to use safe computing practices in general.

The section further includes a provision creating an obligation to make certain records of identity theft victims more available to those victims and law enforcement. This section requires businesses that enter into a commercial transaction for consideration with a person who allegedly has made unauthorized use of a victim's identification to provide a copy of the application and business transaction records evidencing the transaction under the businesses' control within 30 days of the victim's request. The records are to be provided directly to the victim or to a law enforcement agency authorized by the victim to receive the records. The business can require proof of the identity of the victim and proof of the claim of identity theft, including a police report and an affidavit of identity theft developed by the FTC or otherwise acceptable to the business. A business may decline to provide the records if in good faith it determines that this section does not require it to; it does not have a high degree of confidence it knows the true identity of the requester; the request is based on a relevant misrepresentation of fact; or the information is navigational data or similar information about a person's visit to a website or online service. The business is not required under this section to retain any records (the obligation only applies to applications and transaction records that the business already is retaining under its otherwise applicable record retention policy), nor is it required to provide records that do not exist or are not reasonably available (such as those that are not easily retrieved, in contrast to records such as periodic statements listing transactions made on a credit or deposit account that are easily

retrieved). Businesses are also not required to produce records not within their direct control.

**Section 152. Blocking of information relating to identity theft**

This section provides that a consumer reporting agency must block information identified as resulting from identity theft within 4 business days of receiving from the consumer appropriate proof of identity, a copy of an identity theft report, an identification of the fraudulent information, and confirmation that the transaction was not the consumer's. The agency must then promptly notify the furnishers of the information identified that the information may have resulted from identity theft, that an identity theft report has been filed, that a block on reporting the information has been requested, and the effective date of the block.

**Section 153. Coordination of identity theft complaint investigations**

This section directs nationwide consumer reporting agencies to develop and maintain procedures for referring consumer complaints of identity theft and requests for blocks or fraud alerts to the other nationwide agencies, and to provide the FTC with an annual summary of this information. That summary may be a brief description of the estimated number of calls received pertaining to identity theft, the number of fraud alerts requested, and other issues which may be relevant. The FTC, in consultation with the Federal banking agencies and the NCUA, is directed to develop model forms and model standards for identity theft victims to report fraud to creditors and consumer reporting agencies.

**Section 154. Prevention of repollution of consumer reports**

This section creates a national standard governing the duties of furnishers to block refurnishing information that is allegedly the result of identity theft. Specifically, companies that furnish information to a consumer reporting agency are required to establish reasonable procedures to block the refurnishing of the information if they have received a notification from the agency that the information furnished has been blocked because it resulted from identity theft. Similarly, if a consumer submits an identity theft report to a company furnishing information to a consumer reporting agency and states that the information resulted from identity theft, the furnisher may not furnish the information to any consumer reporting agency, unless the furnisher subsequently knows or is informed by the consumer that the information is correct.

The section also restricts the sale or transfer of debt caused by identity theft. This provision applies to any entity collecting a debt after the date it is appropriately notified that the debt has resulted from an identity theft. The entity is then prohibited from selling, transferring, or placing for collection the debt that is identity theft-related. The prohibition does not apply to the repurchase of a debt where the assignee of the debt requires such repurchase because the debt results from identity theft; the securitization of debt (public or private) or the pledge of a portfolio of debt as collateral in connection with a borrowing; or the transfer of debt as a result of a merger, acquisition, purchase and assumption transaction or transfer of substantially all of the assets of an entity.

**Section 155. Notice by debt collectors with respect to fraudulent information**

This section requires third-party debt collectors who are notified that the debts they are attempting to collect may be the result of identity theft or other fraud to notify the

third party on whose behalf they are collecting the debt that the information may be the result of identity theft or fraud. The debt collector must also then, upon the request of the consumer to whom the debt purportedly relates, provide the consumer with all the information that the consumer would be entitled to receive if the information were not the result of identity theft and the consumer were disputing the debt under applicable law.

**Section 156. Statute of limitations**

This section extends the statute of limitations for violations of the Fair Credit Reporting Act. The section requires claims to be brought within 2 years of the discovery of the violation (instead of the original standard of 2 years after the date on which the violation occurred), but with an outside restriction that all claims must be brought within 5 years of when the violation occurred.

**Section 157. Study on the use of technology to combat identity theft**

This section directs the Secretary of the Treasury, in consultation with the Federal banking agencies, the FTC, and other specified public and private sector entities, to conduct a study of the use of biometrics and other similar technologies to reduce the incidence of identity theft.

**TITLE II—IMPROVEMENTS IN USE OF AND CONSUMER ACCESS TO CREDIT INFORMATION**

**Section 211. Free consumer reports**

This section provides consumers with new rights to obtain an annual free consumer report from each of the nationwide credit bureaus (including the nationwide specialty consumer reporting agencies). With respect to agencies defined in 603(p), the free report only has to be provided if the consumer makes the request through the centralized source system established for such purpose. The centralized source shall be established in accordance with regulations prescribed by the FTC in a manner to ensure that the consumer may make a single request for the free reports using a standardized form for mail or Internet. With respect to the nationwide specialty consumer reporting agencies (as defined in 603(w)), the FTC may prescribe a streamlined process for consumers to request their free reports directly from that agency, which shall include, at minimum, the establishment of a toll-free telephone number by each agency, and shall take into account the costs and benefits to each agency of how requests may be fulfilled and the efficacy of staggering the availability of requests to reduce surges in demand.

The nationwide consumer reporting agencies must provide the report to the consumer within 15 days. Any disputes raised by a consumer who receives a free report under this section must be reinvestigated within 45 days after the consumer raises the dispute, which is a 15-day increase over the 30-day reinvestigation time frame that would otherwise apply. The new right to free reports shall not apply to any agency that has not been furnishing consumer reports to third parties on a continuing basis for the 12 months previous to a request. This exclusion is intended to allow credit bureaus that have just begun to fully operate on a nationwide basis (as defined in section 603(p) and (w)) a window of time to ramp up for at least 12 straight months before being subjected to the costs of complying with free requests under this section. The FTC is directed to prescribe regulations preventing consumer reporting agencies from avoiding being treated as an agency defined in section 603(p) by manipulating their corporate structure or consumer records in a manner that allows them to operate with essentially identical activities but for a technical difference.

In addition, the FTC is directed to prepare a model summary of the rights of consumers under the FCRA, including: the right to obtain a free consumer report annually and the method of doing so, the right to dispute information in the consumer's credit file, and the right to obtain a credit score and the method of doing so. The FTC is further directed to actively publicize the availability of the summary of rights, and make the summary available to consumers promptly upon request.

**Section 212. Disclosure of credit scores**

This section establishes a Federal standard governing the provision of credit scores to consumers. Consumer reporting agencies are required to make available to consumers upon request (for a reasonable fee that the FTC shall prescribe) the consumer's current or most recently calculated credit score, as well as the range of scores possible, the top 4 factors that negatively affected the score, the date the score was created, and the name of the company providing the underlying file or score. The disclosure of the top factors is intended to be consistent with the provisions of the Equal Credit Opportunity Act (ECOA) requiring a creditor making an adverse action to disclose the principal reasons in a credit score that most contributed to the adverse action. Credit scores are to be derived from models that are widely distributed in connection with mortgage loans or more general models that assist consumers in understanding credit scoring, and must include a disclosure to the consumer stating that the information and credit scoring model may be different than that used by a particular lender.

Credit scores do not include mortgage scores or automated underwriting systems that consider factors other than credit information, such as loan to value ratio. Consumer reporting agencies that do not distribute credit scores in connection with residential mortgage lending or develop scores in connection with assisting credit providers in understanding a consumer's general credit behavior and predicting the future credit behavior of the consumer are not required to develop or disclose any scores under this section. Consumer reporting agencies that distribute scores developed by others are not required to provide further explanation of them or to process related disputes, other than by providing the consumer with contact information regarding the person who developed the score or its methodology, unless the agency has further developed or modified the score itself. Consumer reporting agencies are not required to maintain credit scores in their files.

If a consumer applies for a mortgage loan, and the mortgage lender uses a credit score in connection with an application by the consumer for a closed end loan or establishment of an open end consumer loan secured by 1 to 4 units of residential real property, then the mortgage lender is required to provide the consumer with a free copy of the consumer's credit score. In addition, the lender must provide a copy of the information on the range of scores possible, the top 4 negative key factors used, the date the score was created, and the name of the company providing the underlying file or score, to the extent that the information is obtained from a consumer reporting agency or developed and used by the lender. A lender is not required to provide a proprietary credit score, but instead may provide a widely distributed credit score for the consumer together with the relevant explanatory information regarding the consumer's credit score. Beyond the information provided to the lender by a third party score provider, the lender is only required to provide a notice to the home loan applicant. This notice

includes the contact information of each agency providing the credit score used, and provides specific language to be disclosed to educate consumers about the use and meaning of their credit scores and how to ensure their accuracy.

A mortgage lender that uses an automated underwriting system to underwrite a loan or otherwise obtains a credit score from someone other than a consumer reporting agency may satisfy their obligation to provide the consumer with a credit score by disclosing a credit score and associated key factors supplied by a consumer reporting agency. However, if the lender uses a numerical credit score generated by an automated underwriting system used by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation or their affiliates, and the score is disclosed to the lender, then that score must be disclosed by the lender to the consumer.

Mortgage lenders are not required by this section to explain the credit score and the related copy of information provided to the consumer, to disclose any information other than the credit score or negative key factor, disclose any credit score or related information obtained by the lender after a loan has closed, provide more than 1 disclosure per loan transaction, or provide an additional score disclosure when another person has already made the disclosure to the consumer for that loan transaction.

The only obligation for a mortgage lender providing a credit score under this section is to provide a copy of the information used and received from the consumer reporting agency. A mortgage lender is not liable for the content of that information or the omission of any information in the report provided by the agency. This section and the requirement for mortgage lenders to provide credit scores do not apply to the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation or their affiliates.

Any provision in a contract prohibiting the disclosure of credit scores by a person who makes or arranges loans or a consumer reporting agency is void, and a lender will not have liability under any contractual provision for disclosure of a credit score pursuant to this section.

This section also amends section 605 of the FCRA to provide that if a consumer reporting agency furnishes a consumer report that contains any credit score or other risk score or other predictor, the report must include a clear and conspicuous statement that the number of enquiries was a key factor (as defined in section 609(e)(2)(B)) that adversely affected a credit score or other risk score or predictor if that predictor was in fact one of the key factors that most adversely affected a credit score. This statement will be made in those instances in which the number of enquiries had an influence on the consumer's credit score, and it will thus alert a user of the consumer report when the number of enquiries has had an adverse effect on the consumer's credit score.

This section's technical and conforming amendments clarify the application of certain Federal standards. State laws are preempted with respect to any disclosures required to be made as a result of various provisions of the FACT Act, including the summary of rights to obtain and dispute information in consumer reports and to obtain credit scores, the summary of rights of identity theft victims, providing information to victims of identity theft, and providing credit score and mortgage score disclosures under this section, except for certain State laws governing credit score disclosures that are grandfathered. State laws that regulate the disclosure of credit-based insurance

scores in an insurance activity are similarly not preempted by the requirements of those specific provisions. State laws governing the frequency of credit report disclosures are also preempted, except for certain specific grandfathered laws.

#### *Section 213. Enhanced disclosure of the means available to opt out of prescreened lists*

This section relates to the disclosure that has to be provided in connection with a prescreened offer of credit or insurance using a consumer's credit report. This section provides that the disclosure must include the address and toll-free number for the consumer to request exclusion from certain prescreened lists and must be presented in a format, type size, and manner that is simple and easy for reasonable consumers to understand. The FTC, in consultation with the Federal banking agencies and the NCUA, shall establish regulatory guidance concerning the format of the disclosure within one year of enactment. The length of time a consumer can request to be excluded from lists for prescreened solicitations is increased by this section from 2 years to 5 years. The FTC is directed to publicize on its website how consumers can opt-out of prescreened offers (including through the telephone number now required) and undertake additional measures to increase public awareness of this right. The Federal Reserve Board is directed to study and report to Congress on the ability of consumers to opt out of receiving unsolicited written offers of credit or insurance and the impact further restrictions on these offers would have on consumers.

#### *Section 214. Affiliate sharing*

This section adds a new Section 624 to the FCRA creating a uniform national standard for regulating the use and exchange of information by affiliated entities. While affiliates are allowed to share information without limitation, they may not use certain shared information to make certain marketing solicitations without the consumer receiving a notice and an option to opt-out of receiving those solicitations. Specifically, an entity that receives certain consumer report or experience information from an affiliate that would be a "consumer report" except for the FCRA's affiliate sharing exceptions may not use that information to make a marketing solicitation to the consumer about the products or services of that entity, unless it is clearly and conspicuously disclosed to the consumer that information shared among affiliates may be used for marketing purposes and the consumer is given an opportunity and simple method to opt out of those marketing solicitations. The notice must allow the consumer to prohibit those types of marketing solicitations based on that affiliate's information, but also may allow the consumer to choose from different options when opting out.

The opt-out notice may be provided to the consumer together with disclosures required by any other provision of law, such as the Gramm-Leach-Bliley Act or other information sharing notices required under FCRA. This provision (as well as a parallel coordination and consolidation provision in the rulemaking directions to the regulators) is intended to allow an entity to time its notice to a consumer (after the effective date of the regulations) in the next regularly scheduled mailing to that consumer of other legally required notices. This coordination and consolidation is intended to reduce consumer confusion and avoid duplicative notices and disclosures.

The consumer's election to opt out is effective for at least five years, beginning on the date the person receives the consumer's election, unless the consumer revokes the opt

out or requests a different mutually agreeable period. After the expiration of the five-year period, the consumer must receive another notice and similar opt-out opportunity before the affiliate can send another covered marketing solicitation to the consumer.

There are a number of exceptions to the limitations on the use of affiliate information for marketing solicitations, where notice and opt out are not required. For example, the notice and opt-out do not apply to an entity using affiliate information to make a marketing solicitation to a consumer if the entity already has a pre-existing business relationship with that consumer. An entity that has a pre-existing business relationship with the consumer can send a marketing solicitation to that consumer on its own behalf or on behalf of another affiliate. For the purposes of determining a pre-existing business relationship, an entity and the entity's licensed agent (such as an insurance or securities agent or broker) are treated as a single entity, with the pre-existing business relationships of one imputed to the other.

A pre-existing business relationship exists between an entity and a consumer when, within the previous 18 months, the consumer has purchased, rented, or leased goods or services from the entity, or where some other continuing relationship exists between the consumer and the entity—for example where a financial transaction has been made with respect to the consumer, where the consumer has an active account (such as an unexpired credit card), or where the consumer has an in-force policy or contract. The term "active account" is intended to include any account where continuing legal obligations are in-force (such as a multi-year certificate of deposit) or for which a consumer regularly or periodically receives statements (even if there have been no recent transactions) such as a securities brokerage, bank, or variable annuity account. A pre-existing business relationship also exists when the consumer makes an inquiry or application regarding the entity's products or services during the three-month period immediately preceding the date on which the consumer is sent a solicitation. The financial functional regulators and the FTC are allowed to create further categories of pre-existing business relationships, which is in part intended to build upon the extensive recognition of customer relationships in existing regulations and guidance issued by the regulators under the Gramm-Leach-Bliley Act.

In addition to the pre-existing relationship exception, the notice and opt-out requirements do not apply to a person using information to facilitate communications with an individual for whose benefit the person provides employee benefit or other services pursuant to a contract with an employer related to and arising out of the current employment relationship of the individual participant or beneficiary of an employee benefit plan. The requirements also do not apply to the use of affiliate information to perform services on behalf of an affiliate, unless the affiliate could not send the solicitation itself because of a consumer opt out. Thus, an affiliate cannot act as a servicer for another affiliate and send out solicitations for its own products or services to a consumer who has opted out of receiving such solicitations. However, an entity can send a marketing solicitation on behalf of an affiliate that has a pre-existing business relationship with the consumer regarding the products or services of that affiliate or another affiliate. Furthermore, the notice and opt-out do not apply to a person using information in response to a communication initiated by the consumer, to a consumer request about a product or service, or to solicitations authorized or requested by the consumer. Additionally, the

notice and opt-out are not required where they would conflict with any provision of State insurance law related to unfair discrimination. This last exception is in part intended to enable insurers and agents to continue full compliance nationwide with State laws prohibiting insurers from discriminating against similar risks or placing similar risks in different rating programs, laws that provide for "mutual exclusivity", and "best rate" laws that may require insurers to provide customers with the best qualified rates from among their affiliated entities.

These provisions governing the exchange and use of information among affiliates do not apply to information used to make marketing solicitations if that information was shared into a common database or received by any individual affiliate before the effective date of the regulations implementing this section. Furthermore, the section makes clear that any State law that relates to the exchange and use of information to make a solicitation for marketing purposes is preempted.

The Federal banking agencies, the NCUA, the Securities and Exchange Commission (SEC), and the FTC are directed to prescribe regulations to implement this new section. To the extent that the section is applicable to insurers, it is intended that any enforcement of FCRA would continue to be performed by the State insurance departments. The Federal agencies also must jointly conduct regular studies of the information sharing practices of affiliates of financial institutions and other persons who are creditors or users of consumer reports to examine how that information is used to make credit underwriting decisions regarding consumers.

Finally, the section includes a technical and conforming amendment to Section 603(d)(2)(A) of the FCRA. This amendment is simply intended to integrate the new Section 624 into the FCRA and does not affect the definition of a "consumer report."

**Section 215. Study of the effects of credit scores and credit-based insurance scores on availability and affordability of financial products.**

Section 215 requires the FTC and the Board to study the use of credit scores and credit-based insurance scores on the availability and affordability of financial products.

**Section 216. Disposal of consumer credit information**

Section 216 directs the Federal banking agencies, the NCUA, the SEC and the FTC to issue regulations requiring the appropriate classes of persons that maintain or possess consumer information "derived" from credit reports to properly dispose of such records. The provision clarifies that it does not apply to other types of information (other than consumer report information) and does not impose an obligation to maintain or destroy any information that is not imposed under other laws. The provision does not alter or affect any such requirement, either.

### TITLE III—ENHANCING THE ACCURACY OF CONSUMER REPORT INFORMATION

#### **Section 311. Risk-based pricing notice**

This section establishes a new notice requirement for creditors that use consumer report information in connection with a risk-based credit underwriting process for new credit customers. If a creditor grants credit to a new credit customer "on material terms that are materially less favorable than the most favorable terms available to a substantial proportion of [the creditor's other new] consumers" based on information from a consumer report, the creditor must give the consumer a notice stating that the terms offered to the consumer are based on infor-

mation from a consumer report. Nothing in the section, however, precludes a creditor from providing such a notice to all of its new credit customers, such as in a loan approval letter or other communication that the credit has been granted. Such a notice is not required, however, if the consumer applied for specific material terms and was granted those terms and those terms are not changed after the consumer responds to the credit offer. Also, such a notice is not required if the person has provided or will provide an adverse action notice pursuant to section 615(a) of the FCRA in connection with an application that is declined. In addition, the creditor is provided with flexibility in the timing of providing such notice, which can be given to the consumer at the time of application for credit or, at communication of loan approval, except where the regulations issued under this section specifically require otherwise.

The notice is intended to be a concise notice that includes: a statement that the terms offered are based on information from a consumer report; the name of a consumer reporting agency used by the creditor; a statement that the consumer may receive a free consumer report from that consumer reporting agency; and the consumer reporting agency's contact information for obtaining a free credit report. The creditor is not required to tell the consumer that it has taken or may take any unfavorable action, only that it used or will use credit reporting information in the underwriting process.

The FTC and FRB are directed to jointly prescribe rules to carry out this section. The rules are to address the form, content, time and manner of delivery of the notice; the meaning of the terms used in the section; exceptions to the notice requirement; and a model notice. The section provides creditors with a safe harbor if they maintain reasonable policies and procedures for compliance, and the section is only subject to administrative enforcement by the appropriate Federal agencies.

This section also adds a national uniformity provision prohibiting any State from imposing a requirement or prohibition relating to the duties of users of consumer reports to provide notice with respect to certain credit transactions.

#### **Section 312. Procedures to enhance the accuracy and integrity of information furnished to consumer reporting agencies**

This section directs the Federal banking agencies, the NCUA and the FTC, with respect to entities subject to their respective enforcement authority and in consultation and coordination with one another, to establish and maintain guidelines for use by furnishers to enhance the accuracy and integrity of the information they furnish to consumer reporting agencies. "Accuracy and integrity" was selected as the relevant standard, rather than "accuracy and completeness" as used in sections 313 and 319, to focus on the quality of the information furnished rather than the completeness of the information furnished. The agencies also are directed to prescribe regulations requiring furnishers to establish reasonable policies and procedures for implementing the new guidelines. In developing the guidelines, the agencies are instructed to: identify patterns, practices and specific forms of activity that can compromise the accuracy and integrity of the information furnished; review the methods used to furnish information; determine whether furnishers maintain and enforce policies to assure the accuracy and integrity of information furnished to consumer reporting agencies; and examine the policies and processes that furnishers employ to conduct investigations and correct inaccurate information.

In addition, this section modifies the standard in the FCRA regarding the duty of furnishers to provide accurate information. The FCRA prohibits furnishers from reporting information with knowledge that it is not accurate. The standard in section 623(a)(1) of the FCRA, "knows or consciously avoids knowing that the information is inaccurate," is amended to "knows or has reasonable cause to believe that the information is inaccurate." This section defines the new standard, "knows or has reasonable cause to believe that the information is inaccurate," to mean "having specific knowledge, other than solely allegations by the consumer, that would cause a reasonable person to have substantial doubts about the accuracy of the information."

This section also enables a consumer to dispute the accuracy of the information furnished to a nationwide consumer reporting agency directly with a furnisher under certain circumstances. Specifically, the Federal banking agencies, the NCUA and the FTC are required to jointly prescribe regulations that identify the circumstances under which a furnisher is required to reinvestigate a dispute concerning the accuracy of information contained in a consumer report, based on the consumer's request submitted directly to the furnisher, rather than through the consumer reporting agency. While the section authorizes a consumer to submit a dispute directly to a furnisher, it is not to be used by credit repair clinics to submit disputes on behalf of one or more consumers.

In developing the regulations required by this section, the regulators are directed to weigh the benefits to consumers against the costs on furnishers and the credit reporting system; the impact on the overall accuracy and integrity of consumer reports of requiring furnishers to reinvestigate disputes brought directly by consumers; whether direct contact by the consumer with the furnisher would likely result in the most expeditious resolution of any such dispute; and the potential impact on the credit reporting system if credit repair organizations are able to circumvent the prohibition on their submission of disputes on behalf of one or more consumers.

A consumer who seeks to dispute the accuracy of information directly with a furnisher must: provide a dispute notice directly to such person at the mailing address specified by the person; identify the specific information disputed; explain the basis for the dispute; and include all supporting documentation required by the furnisher to substantiate the basis of the dispute. Upon receipt of a consumer's notice of dispute, the furnisher has specified responsibilities. The furnisher must: conduct an investigation of the disputed information; review all relevant information provided by the consumer with the notice; and complete the investigation and report the results to the consumer before the expiration of the period under section 611(a)(1) "within which a consumer reporting agency would be required to complete its action if the consumer had elected to dispute the information under that section." Accordingly, for example, where the agency would have 30 days to complete the investigation of disputes regarding a consumer report obtained by the consumer following receipt of an adverse action notice, the furnisher would have 30 days as well. Similarly, where the consumer reporting agency has 45 days to complete a reinvestigation of a consumer dispute because the consumer has requested a consumer report through the centralized system under section 612, a furnisher also would have the 45 days to complete an investigation if the consumer has requested a consumer report through the centralized system and then disputed information on that consumer report directly with the furnisher. In



addition, if the investigation finds that the information reported was inaccurate, the furnisher must promptly notify each consumer reporting agency to which information was furnished and provide the agency with any correction necessary to make the information accurate.

The furnisher requirements do not apply if the person receiving a notice of a dispute directly from a consumer reasonably determines that the dispute is frivolous or irrelevant. Upon making such a determination, the person must notify the consumer of this determination within five business days after making the determination, by mail, or if authorized by the consumer for that purpose, by any other means available to the person. The notice provided to the consumer must include the reasons for the determination, and identification of any information required to investigate the disputed information, which may consist of a standardized form describing the general nature of the information.

This section also amends section 623(a)(5) of the FCRA to provide that a person that furnishes information to a consumer reporting agency regarding a delinquent account may rely upon the date provided by the entity to whom the account was owed at the time that the delinquency occurred, so long as a consumer has not disputed such information.

Section 623 of the FCRA also is amended to clarify liability and enforcement under the FCRA. Specifically, the new requirements imposed upon furnishers of information are subject to administrative enforcement, not private rights of action. Section 623 is amended by providing that "Except as provided in section 621(c)(1)(B), sections 616 and 617 do not apply to any violation of" the furnisher responsibilities under section 623(a), the accuracy guidelines and regulations under section 623(e) and the red flag guidelines and regulations and the requirements dealing with the prohibition of the sale or transfer of a debt caused by identity theft under sections 615(e) or (f) respectively. As a result, the various sections cited in section 312(e) will be subject to the administrative enforcement mechanisms provided under the FCRA, and such mechanisms represent the exclusive remedy for violations of such sections. A similar rule applies to any other section of the legislation that limits enforcement remedies to those administrative remedies set forth under the FCRA, including section 151, which adds a new section 609(e) relating to assistance to identity theft victims.

#### *Section 313. FTC and consumer reporting agency action concerning complaints*

This section directs the FTC to compile a record of complaints against nationwide consumer reporting agencies. If a complaint is received by the FTC about the accuracy or completeness of information maintained by a consumer reporting agency, the FTC must transmit the complaint to the consumer reporting agency for response. Each nationwide consumer reporting agency under section 603(p) that receives a complaint from the FTC must: review the complaint to determine if the agency has met all legal obligations imposed under the FCRA; report to the FTC the determinations and actions taken by the agency with respect to the complaint; and maintain, for a reasonable time, records regarding the disposition of such complaint in a manner sufficient to demonstrate compliance with the FCRA.

In addition, the FTC and the Board are directed to study and report jointly on the performance of consumer reporting agencies and furnishers of credit reporting information in complying with the FCRA's proce-

dures and time frames for the prompt investigation and correction of disputed information in a consumer's credit file.

#### *Section 314. Improved disclosure of the results of reinvestigation*

This section amends sections 611 and 623 of the FCRA to require consumer reporting agencies to promptly delete information from a consumer's file, or modify that item of information as appropriate, if the information is found to be inaccurate, and to promptly notify the furnisher of that information that the information has been modified or deleted from the consumer's file. In addition, this section requires that furnishers, upon completion of a reinvestigation, if the information is found to be inaccurate or incomplete or cannot be verified, must, for purposes of subsequently reporting to a consumer reporting agency, modify the item of information, delete the information, or block the reporting of the information.

#### *Section 315. Reconciling addresses*

This section amends section 605 of the FCRA to require a nationwide consumer reporting agency under section 603(p), when it provides a consumer report, to inform the user requesting that report if the request received from the user includes an address for the consumer that substantially differs from the addresses in the file of the consumer. The Federal banking agencies, the NCUA and the FTC are directed to prescribe regulations regarding reasonable policies and procedures that users of consumer reports within the agencies' respective enforcement jurisdiction should employ when they receive notice of an address discrepancy. These regulations are to describe reasonable policies and procedures that a user may employ to form a reasonable belief that the user knows the identity of the person to whom the consumer report pertains and, if the user establishes a continuing relationship with the consumer, to furnish the consumer reporting agency with the appropriate address, as part of information that the user regularly furnishes for the period in which the relationship is established.

#### *Section 316. Notice of dispute through reseller*

This section amends section 611 of the FCRA to require consumer reporting agencies to reinvestigate consumer disputes forwarded to them by resellers of consumer reports. Furthermore, if a reseller receives notice from a consumer of a dispute concerning the accuracy or completeness of any item of information contained in a consumer report, the reseller must, within five business days and free of charge, determine the accuracy or completeness of the information in question and either correct or delete it, if it is the reseller's error, within 20 days after receiving the notice, or convey the notice of dispute with any relevant information to each consumer reporting agency that provided the information that is the subject of the dispute, if the error is not the reseller's. In the latter circumstance, the consumer reporting agency must report the results of its reinvestigation to the reseller that conveyed the notice, and the reseller must then re-convey the notice to the consumer immediately.

#### *Section 317. Reasonable reinvestigation required*

This section amends section 611 of the FCRA to provide that when a consumer disputes the accuracy of information contained in a consumer report, the consumer reporting agency that prepared the report must conduct a reasonable investigation free of charge to determine whether the disputed information is inaccurate.

#### *Section 318. FTC study of issues relating to the Fair Credit Reporting Act*

This section requires the FTC to study and report to Congress within one of the date of enactment of the FACT Act on ways to improve the operation of the FCRA. The FTC is directed to study and report on: the efficacy of increasing the number of points of identifying information that a credit reporting agency must match before releasing a consumer report; the extent to which requiring additional points of identifying information to match would enhance the accuracy of credit reports and combat the provision of incorrect consumer reports to users; the extent to which requiring an exact match of first and last name, social security number and address and ZIP Code of the consumer would enhance the likelihood of increasing the accuracy of credit reports; and the effects of allowing consumer reporting agencies to use partial matches of social security numbers and name recognition software. The FTC also must report on the impact of providing independent notification to consumers when negative information is included in their credit reports, and to consider the effects of requiring that consumers who experience adverse actions receive a copy of the same credit report used by the creditor in taking the adverse action. Finally, the FTC is to study and report on common financial transactions not generally reported to consumer reporting agencies that may bear on creditworthiness, and possible actions to encourage the reporting of such transactions within a voluntary system.

#### *Section 319. FTC study of the accuracy of consumer reports*

This section directs the FTC to conduct an ongoing study of the accuracy and completeness of information contained in consumer reports, and to submit interim reports and a final report to Congress on its findings and conclusions, together with recommendations for legislative and administrative action.

#### **TITLE IV- LIMITING THE USE AND SHARING OF MEDICAL INFORMATION IN THE FINANCIAL SYSTEM**

##### *Section 411. Protection of medical information in the financial system*

Section 411 amends section 604 of the FCRA to generally prohibit a consumer reporting agency from providing credit reports that contain medical information for employment purposes or in connection with a credit or insurance transaction (including annuities). Medical information may be included in a report as part of an insurance transaction only with the consumer's affirmative consent. Medical information may be included in a report for employment or credit purposes only where the information is relevant for purposes of processing or approving employment or credit requested by the consumer and the consumer has provided specific written consent, or if the information meets certain specific requirements and is restricted or reported using codes that do not identify or infer the specific provider or nature of the services, products, or devices to anyone other than the consumer.

In general, creditors are prohibited from obtaining or using medical information in connection with any determination of a consumer's eligibility for credit. Certain exceptions are provided where authorized by Federal law, for insurance activities (including annuities), and where determined to be necessary and appropriate by a regulation or order of the FTC or a financial regulator (including the State insurance authorities). Any person who receives medical information through any of the exceptions to this section is prohibited from further disclosure

of the information to any other person, except as necessary to carry out the purpose for which it was originally disclosed or as otherwise permitted by law. The Federal banking agencies and the NCUA are directed to prescribe regulations that are necessary and appropriate to protect legitimate business needs with respect to the use of medical information in the credit granting process, including allowing appropriate sharing for verifying certain transactions as well as for debt cancellation contracts, debt suspension agreements, and credit insurance that are generally not intended to be restricted by this provision.

This section further amends section 603(d) of the FCRA to restrict the disclosure among affiliates of consumer reports that are medical information except as provided in the exceptions above. Specifically, the exclusions from the term "consumer report" in section 603(d)(2) (e.g., sharing among affiliates of transaction and experience information) do not apply if the information is medical information, an individualized list or description based specifically on the payment transactions of the consumer for medical products and services, or an aggregate list of consumers identified based on their payment transactions for medical products or services. The section also creates a new definition for the term "medical information", defining it as information derived through a health care provider with respect to an individual consumer relating to the individual's past, present, or future physical, mental, or behavioral health, the provision of health care to the individual, or the payment for the provision of health care to the individual. The definition specifically excludes information that is age, gender, demographic information (including addresses), or other information unrelated to the individual consumer's physical, mental, or behavioral health.

**Section 412. Confidentiality of medical contact information in consumer reports**

Section 412 requires furnishers whose primary business is providing medical services, products, or devices to notify the consumer reporting agencies of their status as a medical information furnisher for purposes of compliance with the medical information coding requirements. Once an entity notifies a consumer reporting agency of its status as a medical information furnisher, the agency may not include in a consumer report the furnisher's name, address, or telephone number unless that contact information is encoded in a manner that does not identify or infer to anyone other than the consumer the specific company or the nature of the medical services, products, or devices provided. An exception is provided for consumer reports provided to insurance companies for insurance activities (including annuities) other than property and casualty insurance. The encoding requirement for medical information furnisher contact information applies regardless of the dollar amounts involved.

**TITLE V—FINANCIAL LITERACY AND EDUCATION IMPROVEMENT**

**Section 511. Short title**

This section establishes the short title of "Financial Literacy and Education Improvement Act."

**Section 512. Definitions**

This section defines the terms "Chairperson" and "Commission" for purposes of this title.

**Section 513. Establishment of Financial Literacy and Education Commission**

This section establishes the Financial Literacy and Education Commission with the

Secretary of the Treasury as the Chairperson. The section sets forth the membership of the Commission to include federal agencies with significant financial literacy programs, and authorizes the President to designate up to five additional members. The Commission is required to meet at least once every four months and all such meetings shall be open to the public. The initial meeting shall take place not later than 60 days after the date of enactment of the FACT Act.

**Section 514. Duties of the Commission**

This section sets forth the duties of the Commission to, among other things, review financial literacy and education efforts throughout the federal government; to identify and eliminate duplicative federal financial literacy efforts; to coordinate the promotion of federal financial literacy efforts including outreach between federal, state and local governments, non-profit organizations and private enterprises; to increase awareness and improve development and distribution of multilingual financial literacy and education materials; to improve financial literacy and education through all other related skills, including personal finance and related economic education; to develop and implement within 18 months a national strategy to promote financial literacy and education among all Americans; and to issue a report, the Strategy for Assuring Financial Empowerment ("SAFE Strategy"), to Congress within the first 18 months of the Commission's first meeting and annually thereafter, on the progress of the Commission in carrying out this title. The Commission also shall establish a website and a toll-free number as a one-stop-shop for all federal financial literacy programs. The Commission's Chairperson is required to provide annual testimony to the relevant congressional committees.

**Section 515. Powers of the Commission**

This section authorizes the Commission to hold hearings and receive testimony as necessary to carry out the title; to receive information directly from any Federal department or agency; to undertake periodic studies regarding the state of financial literacy; and to take any action to develop and promote financial literacy and education materials in languages other than English, as the Commission deems appropriate.

**Section 516. Commission personnel matters**

This section provides that members of the Commission shall serve without compensation in addition to that received for their primary duties, however, the Commission may pay for travel expenses of members for official duties of the Commission. In addition, the Director of the Office of Financial Education of the Treasury Department shall provide assistance to the Commission. The section also permits federal employees to be detailed to the Commission.

**Section 517. Studies by the Comptroller General**

This section mandates that the General Accounting Office (GAO) submit a report to Congress not later than 3 years after the date of enactment of the FACT Act on the effectiveness of the Commission, and conduct a separate study to assess the extent of consumers' knowledge and awareness of credit reports, credit scores, and the dispute resolution process, and on methods for improving financial literacy. The GAO is required to report the findings and conclusions of this study to Congress within a year of the date of enactment.

**Section 518. The national public service multimedia campaign to enhance the state of financial literacy**

This section directs the Secretary of the Treasury, after review of the recommenda-

tions of the Financial Literacy and Education Commission, to develop, in consultation with nonprofit, public, or private organizations, a pilot national public service multimedia campaign to enhance the state of financial literacy and education in the U.S. The campaign is required to be consistent with the national strategy developed pursuant to section 514, and to promote the toll-free telephone and the website required by that section.

The Secretary shall develop measures to evaluate the performance of the public service campaign for each fiscal year for which there are appropriations, and shall submit a report to the Committee on Banking, Housing, and Urban Affairs and the Committee on Appropriations of the Senate and the Committee on Financial Services and the Committee on Appropriations of the House of Representatives, describing the status and implementation of the provisions of this section and the state of financial literacy and education in the United States. Appropriations of \$3 million are authorized for fiscal years 2004, 2005, and 2006, for the development, production, and distribution of the pilot national public service multimedia campaign.

**Section 519. Authorization of appropriations**

This section authorizes appropriations to the Commission of such sums as may be necessary to carry out this title, including administrative expenses.

**TITLE VI—PROTECTING EMPLOYEE MISCONDUCT INVESTIGATIONS**

**Section 611. Certain employee investigation communications excluded from definition of consumer report**

This title amends section 603 of the FCRA to provide that communications to an employer by an outside third party retained to investigate suspected workplace misconduct or compliance with legal requirements or with the employer's preexisting written policies do not constitute a "consumer report" for purposes of the FCRA. This provision is intended to address the ill effects of certain regulatory guidance issued by the FTC staff in 1999 that had the unintended consequence of deterring employers from using outside firms to investigate alleged employee misconduct, including racial discrimination and sexual harassment claims. Employers that take an adverse action based on the communication by the outside investigative agency, however, continue to be required to disclose to the employee a summary of the nature and substance of the communication, although certain sources of information are protected from disclosure. In particular, the disclosure duty is not intended to require violation of any confidentiality obligations, such as confidentiality requirements regarding an individual's medical or other private information (social security number, home residence, etc.), or privileges, such as doctor-patient, attorney-client, or state secrets.

**TITLE VII—RELATION TO STATE LAWS**

**Section 711. Relation to state laws**

Section 711 eliminates the January 1, 2004 sunset of the uniform national consumer protection standards contained in current law and makes those preemptions permanent. It also clarifies that all of the new consumer protections added by the FACT Act are intended to be uniform national standards, by enumerating as additional preemptions the 11 new provisions of the FACT Act that do not contain specific preemptions in those sections. Specifically, the section establishes national uniform standards and preempts State law with respect to the truncation of credit card and debit card numbers (113), establishing fraud alerts (112), blocking information resulting from identity theft

(152), truncating social security numbers on consumer reports given to consumers (115), providing free annual disclosures (211) (in addition to the preemption for disclosures provided under section 212), any consumer protections addressed under the red flag guidelines (114), prohibiting the transfer of debt caused by identity theft (154), notice by debt collectors with respect to fraudulent information (155), coordination of identity theft complaints by consumer reporting agencies (153), duties of furnishers to prevent refurnishing of blocked information (154), and the disposal of consumer report information (216). Under this new preemption provision, no state or local jurisdiction may add to, alter, or affect the rules established by the statute or regulations thereunder in any of these areas. All of the statutory and regulatory provisions establishing rules and requirements governing the conduct of any person in these specified areas are governed solely by federal law and any State action that attempts to impose requirements or prohibitions in these areas would be preempted. This section also clarifies that with respect to any State laws for the prevention or mitigation of identity theft that address conduct other than those for which a national uniform standard is created under FCRA, those laws are not preempted to the extent they are not inconsistent with FCRA.

#### TITLE VIII—MISCELLANEOUS

##### Section 811. Clerical amendments

Section 811 makes a number of technical and clerical amendments.

#### HONORING THE MEMORY OF THE HON. DEVON WIGGINS

##### HON. JO BONNER

OF ALABAMA

IN THE HOUSE OF REPRESENTATIVES

Monday, December 8, 2003

Mr. BONNER. Mr. Speaker, Escambia County, AL, and indeed the entire First Congressional District, recently lost a dear friend, and I rise today to honor him and pay tribute to his memory.

Judge Devon Wiggins was a devoted family man and dedicated public servant throughout his entire life. Following a lengthy tenure on the Escambia County Commission, twelve years of which he spent as the commission chairman, Judge Wiggins was elected to the position of Judge of Probate, a position he held until his retirement three years ago. Throughout his professional career, he was dedicated to bringing better opportunities to all the residents of Escambia County and was a tireless advocate for local business and industry. He also was dedicated to making himself and other county offices as accessible as possible to the general public and, through his efforts, garnered the respect and admiration of many individuals in both the public and private sectors.

As a small business owner in Brewton, Alabama, Judge Wiggins was extremely familiar with the challenges and goals of running a successful business and providing employment opportunities for hardworking men and women. It was this background and his tremendous work ethic which became hallmarks of his career in public office and which marked his efforts on behalf of all residents of Escambia County.

Judge Wiggins was also actively involved in his community, participating in church-related

organizations and taking a leadership role in the activities of the Brewton Lions Club. His devotion to his fellow man was unmatched, and I do not think there will ever be a full accounting of the many people he helped over the course of his lifetime.

Mr. Speaker, I ask my colleagues to join me in remembering a dedicated public servant and long-time advocate for Escambia County, Alabama. Judge Wiggins will be deeply missed by his family—his wife, Nell Wiggins, his daughters, Dawn Wiggins Hare, Donna Wiggins Schlager, and Daphne Wiggins Martin, his son, Maxwell Devon Wiggins, and his six grandchildren—as well as the countless friends he leaves behind. Our thoughts and prayers are with them all at this difficult time.

#### TRIBUTE TO ROSS FISCHER

##### HON. STEVE BUYER

OF INDIANA

IN THE HOUSE OF REPRESENTATIVES

Monday, December 8, 2003

Mr. BUYER. Mr. Speaker, one of the most rewarding aspects of representing Indiana's Fourth District is to have the opportunity to honor outstanding Hoosiers for his or her contributions to the community, State, and Nation.

For over fifty years, Ross Fischer has been the owner and President of McCord Auto Supply in Monticello, Indiana. McCord is the largest distributor of flotation tires in the world—a device of which Ross was instrumental in its design and development.

Ross Fischer was born in 1931 and grew up on a farm in Cissna Park, Illinois. He attended Possum Trot, a one-room schoolhouse.

He served in the United States Army, from 1952–1955 as the Squad Leader in the Alaskan Recoiless Rifle Regiment.

Throughout his over 40 years in Monticello, he has never forgotten his beginnings and it shows everyday in his treatment and compassion of others. Ross has made enormous contributions to the city, including providing free tire repairs to the community after a 1974 tornado. He is a member and supporter of the American Legion, the John Purdue Club, and the Monticello Jaycees and also sits on the Board of the White County Airport.

He and his wife Beverly are the parents of three daughters—Jo Anna, De Anna, Anna Lyn, as well as grandparents to seven grandchildren.

On the eve of his retirement from McCord, as well as his 49th wedding anniversary, I salute Ross Fischer for his dedication to family, community and the State of Indiana.

#### HONORING RANDY STRUCKOFF OF GRINNELL, KANSAS

##### HON. JERRY MORAN

OF KANSAS

IN THE HOUSE OF REPRESENTATIVES

Monday, December 8, 2003

Mr. MORAN of Kansas. Mr. Speaker, I rise today to honor a devoted member of the Grinnell, Kansas community, Randy Struckoff.

Coach Randy, as he is affectionately called, has become one of the most well known sports fans in Northwest Kansas. At every game in the Grinnell high school gymnasium,

Coach Randy always sits at the end of the score table, right next to the home team's bench. On December 19th, USD 291, the Grinnell Public School District, will honor Coach Randy by dedicating the high school's brand new score table to him.

A life-long resident of Grinnell, Coach Randy has touched the lives of all who have had the opportunity to know him. Although born with a mental handicap, he has never let that challenge get him down. Randy has a smile on his face year-round, and his bright spirit helps to carry Grinnell sports teams through hard times and add to their joy during the good times.

Coach Randy's love for his community, its schools, and its youth is visible to everyone around him. Whether he is helping to coach, officiate, lead cheers, or do all three at once, Coach Randy gives his heart and soul in supporting the coaches, students, and entire community. During the playing of the national anthem at any sporting event in Grinnell, Coach Randy stands at rapt attention, singing along with every word. He is present during every sports season, through summer league baseball and softball, football and volleyball in the fall, basketball in winter, and track in the spring.

I join Grinnell, Kansas in thanking Coach Randy for all of his encouragement and his dedication to the community.

#### HONORING THE LIFE OF BARBER B. CONABLE, JR.

##### HON. THOMAS M. REYNOLDS

OF NEW YORK

IN THE HOUSE OF REPRESENTATIVES

Monday, December 8, 2003

Mr. REYNOLDS. Mr. Speaker, I rise before the House of Representatives today in remembrance of a great man who once served in Congress—former Representative Barber B. Conable, Jr. During his twenty years in Congress he represented both his constituents and this institution with grace and integrity. Regardless of where his service led him, Barber always remained true to his Western New York roots.

While he distinguished himself as a Member of Congress and earned the respect of colleagues on both sides of the aisle, Barber was also notable for his esteemed academic career, his professional knowledge on a wide variety of issues from taxes to Social Security, and his willingness to tackle any problem head on. Always lending a helping hand was a signature trait of Barber's; he never let partisanship get in the way of progress.

Barber Conable was the best example of what a public servant ought to be. He loved his country, his community and his family, never straying from the strong values he was raised on. His genuine sophistication as a legislator came so effortlessly, revealing the compassion and unselfishness that was a hallmark of his public service.

In devoting his life to serving others, Barber exemplified loyalty to his country as a veteran of both World War II and the Korean War. With a thirst for knowledge, Barber shared his experiences when he taught at the University of Rochester and later went on to become President of the World Bank. Though no matter what national or global stage he was on,



## ATTACHMENT II

### Regulatory Effective Dates for Various Provisions of FACT Act

12/13/2003 Effective dates for FCRA preemption provisions:

<b>Section</b>
151(a)(2)
212(e)
214(c)
311(b)
711

03/31/2004 Effective dates for "self-effectuating" provisions without a specific effective date:

<b>Section</b>	<b>Provision</b>
111	Definitions
156	Statute of limitations
312(d)	Furnisher liability exemption
312(e)	Liability and enforcement
312(f)	Rule of construction
313(a)	Action concerning complaints
611	Communications for certain employee investigations
811	Clerical amendments

12/31/2004 Effective dates for provisions requiring changes to systems, disclosure forms or practices, or regulations:

<b>Section</b>	<b>Provision</b>
112	Fraud alerts and active duty alerts
114	Procedures for identification of possible instances of identity theft
115	Truncation of social security number in consumer report
151(a)(1)	Summary of rights of ID theft victims
152	Blocking information resulting from identity theft
153	Coordination of ID theft complaint investigations

<b>Section</b>	<b>Provision</b>
154	Repollution of consumer reports
155	Notice by debt collectors with respect to fraudulent information
211(c)	Summary of rights of consumers
212(a)-(d)	Disclosure of credit scores by CRA's
213(c)	Enhanced disclosures of means to opt-out of pre-screened lists
217(a)	Duty to provide notice to consumer (of report to CRA of adverse information)
311(a)	Risk-based pricing notice
314	Improved disclosure of results of reinvestigations
315	Reconciling addresses
316	Notice of dispute through reseller
317	Duty to conduct reasonable reinvestigations

Sections that become effective upon effective date of implementing rules

<b>Section</b>	<b>Provision</b>
211(a)	Free consumer reports. (Comments due on proposed regulation by April 16)
214	Affiliate sharing for marketing purposes. Rules must be issued by September 4, 2004 to become effective no later than 6 months after (March 4, 2005).
216	Disposal of consumer report information and records. (Regs. by December 4, 2004).



**TAX AND STRUCTURAL ISSUES FOR  
BANKS AND FINANCIAL INSTITUTIONS:  
A LAUNDRY LIST OF ISSUES AND CONCEPTS**

*Walter R. Byrne, Jr.  
Stites & Harbison PLLC  
Lexington, Kentucky*

*Thomas J. Luber  
Wyatt, Tarrant & Combs, LLP  
Louisville, Kentucky*

Copyright 2004. Walter R. Byrne, Jr. and Thomas J. Luber. All Rights Reserved.

**SECTION K**



**TAX AND STRUCTURAL ISSUES FOR BANKS  
AND FINANCIAL INSTITUTIONS:  
A LAUNDRY LIST OF ISSUES AND CONCEPTS**

<b>I.</b>	<b>INTRODUCTION .....</b>	<b>K(a)-1</b>
<b>II.</b>	<b>POTENTIAL STRUCTURAL CHANGES TO ALLEVIATE THE KENTUCKY CORPORATE LICENSE TAX IF KENTUCKY LAW IS NOT CHANGED .....</b>	<b>K(a)-2</b>
<b>III.</b>	<b>OTHER STRUCTURAL ISSUES .....</b>	<b>K(a)-4</b>

**APPENDIX:**

Exhibit A:	HB 319 .....	K(a)-7
Exhibit B:	OCC - Organizational Changes .....	K(a)-11
Exhibit C:	12 CFR Part 5 - Fundamental Change in Asset Composition of a Bank .....	K(a)-25



**TAX AND STRUCTURAL ISSUES FOR BANKS  
AND FINANCIAL INSTITUTIONS:  
A LAUNDRY LIST OF ISSUES AND CONCEPTS**

Walter R. Byrne, Jr.  
Stites & Harbison PLLC  
Lexington, Kentucky

I. INTRODUCTION. At the time of preparing this presentation, the Kentucky legislature has not passed legislation to minimize or eliminate the adverse tax consequences to Kentucky holding companies by the decision rendered in a case brought by Illinois Tool Works, Inc., styled Illinois Tool Works, Inc. Individually, and on Behalf of all Other Similarly Situated Taxpayers Denied the Benefits of KRS 136.071 Because Their Commercial Domiciles are Outside Kentucky v. Revenue Cabinet, Commonwealth of Kentucky, Civil Action No. 00-CI-00623 (Jan. 2003) ("ITW Case"). While there is general support for such a bill, there is no agreement at the time of preparing this outline to pass this legislation during the current session. As a result of the ITW Case (which essentially eliminated the exemption contained in KRS 136.071) and without statutory relief, a bank holding company in Kentucky would be required after December 31, 2003 to pay a state license tax on its capital assessed in the amount of \$2.10 per \$1,000 of capital. Thomas J. Lubert, Esq. of Wyatt Tarrant & Combs, LLP has provided a separate presentation on the tax implications of the ITW Case for a bank holding company. Assuming that the legislature does not cure the taxation problem for bank holding companies created by the outcome of the ITW Case, this outline briefly reviews various structural options available to



bank holding companies in Kentucky who desire to mitigate the effect of the ITW Case and briefly reviews other structural changes for banks and bank holding companies as a result of other recent regulatory changes.

II. POTENTIAL STRUCTURAL CHANGES TO ALLEVIATE THE KENTUCKY CORPORATE LICENSE TAX IF KENTUCKY LAW IS NOT CHANGED. Absent a

legislative solution to the inequities caused by the ITW Case, there appears to be no simple structural change that would universally permit Kentucky bank holding companies to avoid the corporate license tax. Because of the various differences in size and degree of complexity involved in bank holding companies located in Kentucky, any advice must be ultimately based upon the specific facts associated with each bank holding company after considering future plans and likely future needs of that entity and general advice involving a reorganization must be carefully presented and considered. Most potential solutions to mitigate the ITW Case have advantages and disadvantages and may not be available in all situations. The Kentucky Bankers Association has previously circulated the below listed potential strategies that may, in some instances, be undertaken by bank holding companies domiciled in Kentucky because of the ITW Case:

1. Do nothing.
2. Convert existing bank holding company that is a general business corporation to a limited liability company ("LLC").
3. Relocate the bank holding company outside of Kentucky.
4. Eliminate the bank holding company and return the shareholders to direct ownership of bank stock.

5. Undertake non-structural creative changes as suggested by Crowe Chizek & Company, LLP, and as suggested by King & Company, PSC which are available to their respective clients.

If the legislature fails this legislative session to provide an acceptable solution to the ITW Case, most financial institutions will want to first hear what, if anything, will likely be forthcoming in the future from the legislature about this issue and the likely timing any solution may take before any final decisions are made to undertake a structural change. Management and the board of directors for each bank holding company located in Kentucky must ultimately make their own business decision as to how to proceed if the Kentucky legislature fails this session to provide an acceptable solution to the ITW Case. This will undoubtedly be undertaken after a careful review of the facts and the goals, both short and long term, of the bank holding company and the costs associated with a reorganization. Most alternative structures that have been proposed have both advantages and disadvantages beyond taxation consideration and because the world we live in is dynamic there may be future issues which may develop that may require additional changes.

In considering which course of action, if any, to pursue, the board of directors of a bank holding company must consider many factors beyond the potential tax savings, including but not limited to the following:

1. What would be the corporate form of the alternative transaction and the cost and time involved to be successful? What are the advantages and disadvantages of this proposal? Is shareholder approval required? Are dissenters' rights available to your shareholders?

2. What bank regulatory approvals or notices may be required to undertake the change and the likely time requirements for each?

3. Whether the undertaking would involve the sale of securities and compliance with federal and blue-sky securities laws?

4. Whether any corporate or contractual rights are affected and whether third party consents are required to be obtained? What about charter and bylaw provisions, shareholder agreements, and third party contracts?

5. If a LLC is proposed, the laws and regulations, as well as the operating agreement may be very different from the laws and regulations, as well as a corporate governance of a general business corporation.

6. Whether future goals and plans for the institution can be accommodated after a change in structure.

7. If redomestication is proposed, what are the differences in laws and regulations of the new state with those of Kentucky? What is the likelihood for the relocated company (whose principal subsidiaries continue to do business in Kentucky) to be taxed in Kentucky after the move? Is there any likelihood that litigation may be possible with the taxing authority?

III. OTHER STRUCTURAL ISSUES. Several recent structural changes by bank regulators are noted:

A. Amendment to KRS 287.920. HB319, attached as Exhibit A to this outline, was approved by the legislature and signed by the governor, and pertains to establishing bank

branches in Kentucky by an interstate merger and, provides for reciprocity with the laws of the home state of the out-of-state bank when permitting out-of-state banks to branch in Kentucky.

B. The Office of the Comptroller of the Currency ("OCC") has issued a final rule allowing nation banks to make organization changes more efficiently. Attached as Exhibit B to this outline is a copy of the OCC final rule which in part permits the following:

1. National banks may reorganize directly to be controlled by a holding company.
2. National Banks may increase maximum term of service for national bank directors and permits to OCC to adopt regulations allowing for staggered terms for directors.
3. National Banks may apply for permission to have more than 25 directors.
4. National Banks may merge with one or more non-bank affiliates after obtaining the OCC's approval.

C. The OCC has issued a proposed rule involving national banks making major asset moves or change in business focus and may require prior written approval from the OCC. The proposed rule is found in the Federal Register, Vol. 69, No. 4, pg. 892-895, January 7, 2004 and attached hereto as Exhibit C.





# KENTUCKY LEGISLATURE

---

## HB319

### WWW Version

NOTE: The hyperlink to a bill draft that precedes a summary contains the most recent version (Introduced/GA/Enacted) of the bill. If the session has ended, the hyperlink contains the latest version of the bill at the time of sine die adjournment. Note that the summary pertains to the bill as introduced, which is often different from the most recent version.

---

HB 319 (BR 1205) - T. Thompson, R. Damron, B. Buckingham

AN ACT relating to establishing bank branches.

Amend KRS 287.920, pertaining to establishing bank branches by an interstate merger, to provide that if the laws of the home state of the out-of-state bank place more restrictive terms or conditions on Kentucky banks seeking to acquire or merge with a bank in the home state of the out-of-state bank, the interstate merger may be allowed in Kentucky only under substantially the same terms and conditions as applicable to Kentucky state banks in the home state of the out-of-state bank.

Jan 20-introduced in House  
 Jan 21-to Banking and Insurance (H)  
 Jan 22-posted in committee  
 Jan 27-posting waived  
 Jan 28-reported favorably, 1st reading, to Calendar  
 Jan 29-2nd reading, to Rules; posted for passage in the Regular Orders of the Day for Friday, January 30, 2004  
 Feb 2-3rd reading, passed 92-0  
 Feb 3-received in Senate  
 Feb 6-to Banking and Insurance (S)  
 Feb 25-reported favorably, 1st reading, to Consent Calendar  
 Feb 26-2nd reading, to Rules  
 Mar 4-posted for passage in the Consent Orders of the Day for Tuesday, March 9, 2004  
 Mar 9-3rd reading, passed 37-0; received in House  
 Mar 10-enrolled, signed by each presiding officer; delivered to Governor  
 Mar 22-signed by Governor (Acts ch. 13)

---

[Kentucky Legislature Home Page](#) | [Record Front Page](#)

AN ACT relating to establishing bank branches.

***Be it enacted by the General Assembly of the Commonwealth of Kentucky:***

Section 1. KRS 287.920 is amended to read as follows:

- (1) As used in this section, unless the context requires otherwise:
  - (a) "Interstate merger transaction" means the merger or consolidation of banks with different home states, and the conversion of branches of any bank involved in the merger or consolidation into branches of the resulting bank; and
  - (b) "Resulting bank" means a bank that has resulted from an interstate merger transaction under this section.
- (2) A Kentucky state bank may establish, maintain, and operate one (1) or more branches in a state other than Kentucky in accordance with an interstate merger transaction in which the Kentucky state bank is the resulting bank, or if the other state permits, by acquisition of a branch or branches in the other state. Not later than the date on which the required application for the interstate merger transaction or branch acquisition is filed with the responsible federal bank supervisory agency, the applicant shall file an application on a form prescribed by the commissioner and pay the fee prescribed by KRS 287.480. The applicant shall also comply with the applicable provisions of KRS 287.180(2) and the commissioner shall base his or her approval or disapproval in the same manner as prescribed in KRS 287.180(2).
- (3) An out-of-state state bank may establish, maintain, and operate one (1) or more branches in Kentucky in accordance with an interstate merger transaction in which the out-of-state state bank is the resulting bank *in accordance with the requirements of Kentucky laws and administrative regulations. If the laws of the home state of the out-of-state bank place more restrictive terms or requirements on Kentucky state banks seeking to acquire and merge with a bank in that state, the interstate merger of the out-of-state bank may be allowed only under*

substantially the same terms and conditions as applicable to Kentucky state banks in that state. Not later than the date on which the required application for the

interstate merger transaction is filed with the responsible federal bank supervisory agency, the applicant shall file an application on a form prescribed by the commissioner, pay the fee prescribed by KRS 287.480, and agree in writing to comply with the laws of this state applicable to its operation of branches in Kentucky. The applicant shall also comply with the applicable provisions of KRS 287.180(2) and the commissioner shall base his or her approval or disapproval in the same manner as prescribed in KRS 287.180(2).

- (4) No interstate merger transaction under subsection (2) or (3) of this section shall be approved if the transaction would result in a bank holding company having control of banks or branches in this state holding more than fifteen percent (15%) of the total deposits and member accounts in the offices of all federally insured depository institutions in this state as reported in the most recent June 30 quarterly report made by the institutions to their respective supervisory authorities which are available at the time of the transaction.
- (5) An individual or bank holding company that controls two (2) or more banks may, from time to time, combine any or all of the commonly controlled banks in this Commonwealth into and with any one (1) of the banks, and thereafter the surviving bank shall continue to operate its principal office and may operate the other authorized offices of the banks so combined as branches of the surviving bank.
- (6) A branch of an out-of-state state bank may conduct any activities that are authorized under the laws of this state for state banks. Additionally, the branch of an out-of-state state bank is authorized to conduct any activities relating to the administration of trusts that are authorized under the laws of its home state, if the activities are conducted in conformity with the laws of its home state.
- (7) A branch of a Kentucky state bank located in a host state may conduct any activities



that are:

- (a) Authorized under the laws of the host state for banks chartered by the host state; or
- (b) Authorized for branches of national banks located in the host state, but whose principal location is in a state other than the host state.

Explorer, the text for the same procedure will be "Save Target As." After clicking on one of these options, you will get a "Save As" pop-up window. Choose where you want to save the document (on your desktop or in another file folder), and click "Save."

Take careful note of where you save the presentation so you can find it easily later. Once the document is downloaded and saved to your PC, you can easily open it later for viewing, printing or editing.

### ¶ 93-732 FDIC Warns of Deceptive Claims of FDIC Insurance Coverage.

Federal Deposit Insurance Corporation. SA-79-2003, December 12, 2003. Alert in full text.

See ¶ 8154.

[SA -79-2003]

TO: CHIEF EXECUTIVE OFFICER (also may be of interest to Security Officer)

SUBJECT: Deceptive Claims of FDIC Insurance Coverage

Summary: *An entity – Banco Atlantico, Madrid, Spain – is falsely representing to potential customers on its Web site that it is a member of the FDIC.*

Please be advised that the Federal Deposit Insurance Corporation (FDIC) was recently notified an entity is unlawfully advertising FDIC membership on its Internet Web site. The Web site is reportedly operated by Banco Atlantico. The Web site indicates that the main office of this institution is located in Madrid, Spain. Specifically, the Web site includes the phrase "Member FDIC." The FDIC **does not** insure

this entity, or any products or services that it may offer.

Any information about this entity may be forwarded to the FDIC's Special Activities Section, 550 17th Street, N.W., Room F-4040, Washington, D.C. 20429, or forwarded electronically to [alert@fdic.gov](mailto:alert@fdic.gov).

For your reference, FDIC Special Alerts may be accessed from the FDIC's Web site at [www.fdic.gov/news/news/SpecialAlert/2003/index.html](http://www.fdic.gov/news/news/SpecialAlert/2003/index.html). To learn how to automatically receive FDIC Special Alerts, Financial Institution Letters and other announcements through e-mail, please visit [www.fdic.gov/news/news/announcements/index.html](http://www.fdic.gov/news/news/announcements/index.html).

**Michael J. Zamorski**

Director

Distribution: FDIC-Supervised Banks (Commercial and Savings)

### ¶ 93-733 OCC Rule Allows National Banks to Make Organizational Changes More Efficiently (12 CFR 3, 5, 6, 7, 9, 28, 34).

Department of the Treasury, Office of the Comptroller of the Currency. 68 *Federal Register* 70122, December 17, 2003. Docket No. 03-24. RIN 1557-AB97. Notice in full text.

See ¶ 10-151; 10-270; 10-282; 10-283; 10-284; 10-354; 10-408; 10-416; 10-474; 10-668; 10-670; 11-416; 11-803.

[OCC Notice]

**ACTION:** Final rule.

**SUMMARY:** The Office of the Comptroller of the Currency (OCC) is publishing a final rule implementing authority provided to national banks by sections 1204, 1205, and 1206 of the American Homeownership and Economic Opportunity Act of 2000 (AHEOA). Section 1204 permits national banks to reorganize directly to be controlled by a holding company. Section 1205 increases the maximum term of service for national bank directors, permits the OCC to adopt regulations allowing for staggered terms for directors, and permits national banks to apply for permission to have more than 25 directors. Section 1206 permits national banks to merge with one or more of their nonbank affiliates, subject to OCC approval. In addition, the rule amends parts 5, 7, 9, and 34, for other purposes and makes several technical corrections.

**EFFECTIVE DATE:** January 16, 2004.

**FOR FURTHER INFORMATION CONTACT:** For questions concerning 12 CFR 5.20, contact Richard Cleva, Senior Counsel, Bank Activities and Structure Division, (202) 874-5300; or Andra Shuster, Counsel, Legislative and Regulatory Activities Division, (202) 874-5090. For questions concerning 12 CFR 5.32, con-

tact Mark Ginsberg, Senior Licensing Analyst, Licensing Policy and Systems Division, (202) 874-5060; or Andra Shuster, Counsel, Legislative and Regulatory Activities Division, (202) 874-5090. For questions concerning 12 CFR 5.33, contact Crystal Maddox, Senior Licensing Analyst, Licensing Policy and Systems Division, (202) 874-5060; Richard Cleva, Senior Counsel, Bank Activities and Structure Division, (202) 874-5300; or Andra Shuster, Counsel, Legislative and Regulatory Activities Division, (202) 874-5090. For questions concerning 12 CFR 7.2024, contact Andra Shuster, Counsel, Legislative and Regulatory Activities Division, (202) 874-5090. For questions concerning 12 CFR 34.3, contact Mark Tenhundfeld, Assistant Director, or Andra Shuster, Counsel, Legislative and Regulatory Activities Division, (202) 874-5090. For questions concerning 12 CFR 9.18, contact Beth Kirby, Special Counsel, Securities and Corporate Practices Division, (202) 874-5210.

**SUPPLEMENTARY INFORMATION:** On February 7, 2003, the OCC published a notice of proposed rulemaking in the *Federal Register* (68 FR 6363) to implement the AHEOA and clarify our visitorial powers regulations (NPRM). In addition, we proposed to amend (1) 12 CFR part 5 concerning limited-purpose banks, factors to be considered in business combinations, and operating subsidiary activities eligible for

after-the-fact notice requirements; (2) 12 CFR part 7 concerning national banks' ability to provide tax advice; (3) 12 CFR part 9 concerning the valuation of collective investment funds; and (4) 12 CFR part 34 to update regulatory text to conform to a statutory change. Various technical changes to correct citations or footnote numbering were also part of the NPRM.

The OCC received a total of 55 comments on the NPRM. Of this number, 34 addressed the parts of the proposal that implemented the AHEOA provisions and amended 12 CFR parts 5, 7, 9, and 34. These comments included two from bank holding companies, four from banking trade associations, one from a community trade association, one from a non-profit consumer group, one from a bank supervisors' trade association, and 25 from state bank supervisors' offices. While many of the commenters supported the proposed changes, many offered suggestions for changes. For the reasons discussed below, we have adopted the provisions of the NPRM with a number of changes in response to the comments received to clarify certain provisions.

Many of the comments we received on the proposal also addressed the revision to our visitorial powers regulation. A number of these comments contained thoughtful and detailed arguments that we will address in a rulemaking to be published separately in the *Federal Register*.

## I. Amendments Implementing the AHEOA

### A. Background

The National Bank Consolidation and Merger Act (12 U.S.C. 215 et seq.) (Merger Act) permits consolidations and mergers involving national banks. Pursuant to 12 U.S.C. 215 and 215a, national banks or state banks<sup>1</sup> may, with OCC approval, merge or consolidate with a national bank located in the same state, resulting in a national bank. National banks also may merge or consolidate with Federal thrifts under 12 U.S.C. 215c, resulting in either a national bank or Federal thrift. Pursuant to 12 U.S.C. 215a-1, an insured national bank may merge or consolidate with an insured bank located in a different state.

Prior to the enactment of the AHEOA on December 27, 2000,<sup>2</sup> the Merger Act did not address mergers or consolidations involving a national bank and its nonbank affiliates. However, section 1206<sup>3</sup> of the AHEOA amended the Merger Act to permit national banks to merge with one or more of their nonbank affiliates with the approval of the OCC (Section 1206 Merger).

Other provisions of the AHEOA liberalize statutory reorganization and corporate governance requirements for national banks. Section 1204<sup>4</sup> amends the Merger Act to expedite the procedures that a national bank may use when it reorganizes to become a subsidiary of a holding company. Section 1205<sup>5</sup> of the

AHEOA liberalizes the requirements governing the number and length of service of national bank directors.

This final rule contains amendments to 12 CFR parts 5 and 7 to implement these changes made by the AHEOA.

### B. Description of the Proposal, Comments Received, and Final Rule

#### 1. Reorganization into a Holding Company Subsidiary—New § 5.32

Pursuant to section 1204 of the AHEOA, a national bank, with the OCC's approval and the affirmative vote of shareholders holding at least two-thirds of the bank's outstanding capital stock, may reorganize to become a subsidiary of a bank holding company or a company that will become a bank holding company through the reorganization.

Proposed new § 5.32 implemented this provision. Paragraph (a) stated the authority for engaging in section 1204 transactions. Paragraph (b) repeated the scope of the statute and provided that § 5.32 applies to a reorganization of a national bank into a subsidiary of a bank holding company or of a company that will become a bank holding company through the reorganization. In order to clarify the types of entities that would be covered under this section, we have added a sentence at the end of paragraph (b) that states that, for purposes of § 5.32, "bank holding company" means any company that owns or controls a national bank, or will own or control one as a result of the reorganization. Thus, the term "bank holding company" is not limited to companies that would be bank holding companies under the definition of the term in the Bank Holding Company Act of 1956 (BHCA).

Pursuant to proposed § 5.32(c), a national bank must submit an application to, and obtain approval from, the OCC prior to participating in a section 1204 reorganization. Paragraph (d) described the procedural requirements for this type of transaction. In accordance with proposed § 5.32(d)(1), the application is deemed approved by the OCC as of the 30th day after the OCC receives it, unless the OCC otherwise notifies the applicant national bank. Approval of applications under § 5.32 is subject to the condition that the bank give the OCC 60 days' prior notice of any material change in its business plan or any material change from the proposed changes described in the bank's plan of reorganization. A few commenters recommended that the OCC give national banks notice that an application has been received and is complete to verify that the application is in process and to ensure that all parties know when the 30-day time period starts to run. We have not revised the proposal in response to this suggestion, however, because our standard application procedure includes sending out an acknowledgment letter that will provide the information the commenters requested.

<sup>1</sup> The term "state bank" is defined by the statute to include state-chartered banks, banking associations, trust companies, savings banks (other than mutual savings banks), and other banking institutions engaged in the business of receiving deposits. 12 U.S.C. 215b. This section also contains other definitions.

<sup>2</sup> Pub. L. 106-569, 114 Stat. 2944.

<sup>3</sup> Pub. L. 106-569, § 1206, 114 Stat. 2944, 3034 (codified at 12 U.S.C. 215a-3).

<sup>4</sup> Pub. L. 106-569, § 1204, 114 Stat. 2944, 3033 (codified at 12 U.S.C. 215a-2).

<sup>5</sup> Pub. L. 106-569, sec 1205, 114 Stat. 2944, 3033-3034 (amending 12 U.S.C. 71 and 71a).

These same commenters also suggested that the OCC provide banks with guidance regarding the type of changes to the business plan that would be material. The OCC has developed a policy addressing the circumstances that constitute a "significant deviation" from a national bank's existing business plan or operations and circumstances under which we will impose a written condition requiring a bank to provide notice of any significant deviation. This "OCC Significant Deviation Policy" is posted on our website as a sample to the Charters Booklet of the Comptroller's Licensing Manual.<sup>6</sup> We expect that this policy will provide the guidance commenters are seeking with respect to the changes we think should prompt the notice required by § 5.32. In order to make the final rule consistent with this Policy, we have changed the references to "material change" in the proposal to "significant deviation."

Paragraph (d)(2) of proposed § 5.32 implemented the statutory requirements that apply to the content of the reorganization plan. The plan must: (1) Specify how the reorganization is to be carried out; (2) be approved by a majority of the national bank's board of directors; (3) specify the amount and type of consideration that the bank holding company will provide for the stock of the bank, the date on which the shareholders' rights to participate in the exchange are to be determined, and the procedure for carrying out the exchange; (4) be submitted to the shareholders of the reorganizing bank at a meeting called in accordance with the procedures outlined in section 3 of the Merger Act;<sup>7</sup> and (5) where applicable, describe any changes to the bank's business plan resulting from the reorganization. Consistent with section 3 of the Merger Act, the proposal also required that at least two-thirds of the bank's shareholders approve a reorganization.

Paragraph (d)(3) of proposed § 5.32 provided that the OCC will review the financial and managerial resources and future prospects of the national bank when considering a section 1204 reorganization.

Proposed § 5.32(e) provided dissenters' rights protections for section 1204 reorganizations. As provided in the Merger Act, this paragraph would permit any shareholder who has voted against the reorganization at a meeting or given notice in writing at or prior to the meeting to receive the value of his or her shares by providing a written request to the bank within 30 days after the consummation of the reorganization.

Section 5.32(f) of the proposal stated that § 5.32 does not affect the applicability of the BHCA to a

transaction covered under § 5.32(b); applicants must indicate in their § 5.32 applications the status of any BHCA application they are required to file with the Board of Governors of the Federal Reserve System.

Proposed paragraph (g) of § 5.32 stated that the OCC's approval of a § 5.32 application will expire if a national bank has not completed the reorganization within one year of the date of such approval. A commenter suggested that the OCC incorporate flexibility into this provision for complicated transactions that may take longer than one year to complete by permitting banks to apply for a waiver of this restriction. We do not think it is necessary to amend the regulation to establish a formal waiver process, but we will evaluate the need for an extension of the standard time frame on a case-by-case basis in accordance with 5.13(g).<sup>8</sup>

Finally, proposed paragraph (h)(1) stated that applicants shall inform shareholders of all material aspects of a reorganization and comply with applicable requirements in the Federal securities laws and the OCC's securities regulations in 12 CFR part 11. Proposed paragraph (h)(2) stated that applicants that are not subject to registration requirements under the Securities Exchange Act of 1934 shall submit proxy materials or information statements used in connection with a reorganization to the appropriate OCC district office no later than when such materials are sent to shareholders.

We received no comments regarding proposed § 5.32 other than those we have discussed. Accordingly, we are adopting this provision as proposed with the changes just described.

## 2. Section 1206 Mergers—Revised § 5.33

Section 1206 of the AHEOA provided new authority for a national bank to merge with one or more of its nonbank affiliates, subject to the OCC's approval. Current § 5.33 sets forth application and notice procedures for national banks entering into business combinations, such as mergers or consolidations, with other national banks or state-chartered banks, as well as OCC review and approval standards for such transactions. The proposal contained amendments to § 5.33 to include Section 1206 Mergers within its scope.

The proposal added new application and prior OCC approval requirements for Section 1206 Mergers at the end of redesignated § 5.33(c). These requirements are similar to those for mergers of a national bank or state bank into a national bank under 12 U.S.C. 215a.

<sup>6</sup> This policy can be found on the OCC's Web site at <http://www.occ.treas.gov/corpbook/forms/SigDevPolicy8-03.pdf>. The policy defines a significant deviation from a bank's business plan or operations to include, but not be limited to, a material deviation or material change in the bank's: (1) Projected growth, such as planning significant growth in a product or service; (2) strategy or philosophy, such as significantly reducing the emphasis of its targeted niche (for example, small business lending) in favor of significant expansion of another area (for example, funding large commercial real estate projects); (3) lines of business, such as initiating a new program for sub-prime lending; (4) funding sources such as shifting from core deposits to brokered deposits; (5) scope of activities, such as establishing transactional Internet banking or entering new, untested markets; (6) stock benefit plans for de novo

banks, including the introduction of plans that were not previously reviewed during the chartering process with no objection by the OCC; and (7) relationships with a parent company or affiliate, such as a shift to significant reliance on a parent or affiliate as a funding source or provider of back office support.

<sup>7</sup> Section 3 of the Merger Act, 12 U.S.C. 215a(a)(2), provides generally that a shareholders' meeting will be called by the bank's directors after publishing notice of the time, place, and object of the meeting for four consecutive weeks in a newspaper of general circulation where the bank is located and after sending notice to each shareholder of record by certified or registered mail at least 10 days prior to the meeting.

<sup>8</sup> This section provides that the OCC generally does not grant extensions unless the delay is beyond the control of the applicant.

A number of new definitions were added to § 5.33(d) in order to implement section 1206. Current § 5.33(d) defines only the terms "business combination," "business reorganization," "home state," and "interim bank." The proposal amended the definition of "business combination" to include Section 1206 Mergers, but left the definitions of the other three terms unchanged.

Proposed § 5.33(d)(1) added a definition of "bank" and defined it as any national bank or state bank. This definition was added because the term is used in the definition for "nonbank affiliate."

Proposed § 5.33(d)(4) defined the term "company" to mean a corporation, limited liability company, partnership, business trust, association, or similar organization. This term was proposed to be added because it is used in the definition of "nonbank affiliate" and "control."

Proposed § 5.33(d)(5) defined "control," which is used in the definition of "nonbank affiliate." Under the proposal, for business combinations under § 5.33(g)(4) and (5), a company or shareholder would be deemed to control another company if (1) the company or shareholder directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 per cent or more of any class of voting securities of the other company; or (2) the company or shareholder controls in any manner the election of a majority of the directors or trustees of the other company.

Because section 1206 provides merger authority for entities previously not included within the scope of § 5.33, the proposal added the definition of "nonbank affiliate" to describe the entities that are covered by section 1206. Proposed § 5.33(d)(8) defined "nonbank affiliate" of a national bank as any company that controls, is controlled by, or is under common control with the national bank. Banks and Federal savings associations were not included as "affiliates" because mergers with such entities are governed by statutes other than section 1206. Nonbank subsidiaries would be considered to be nonbank affiliates for purposes of § 5.33.

Section 5.33(e)(3)(ii) currently requires that, if as a result of a business combination, a national bank obtains control of a new subsidiary, the bank must provide the same information regarding the new subsidiary's activities that would be required if the applicant were establishing a new subsidiary under either 12 CFR 5.34 (which addresses operating subsidiaries) or 12 CFR 5.39 (which addresses financial subsidiaries). The current rule contains an exception if the subsidiary was a subsidiary of a national bank. The proposal modified this provision to take into account the fact that the bank may now merge with a nonbank affiliate that has a subsidiary.

Section 5.33(f) sets forth exceptions to the rules that generally govern the OCC's application procedures, such as requirements for the publication of notice or for hearings. Pursuant to § 5.33(f)(1), a national bank applicant that is subject to specific statutory notice requirements for business combinations is not subject to § 5.8(a), (b), or (c), which requires, and

prescribes the timing and contents of, public notice. Instead, a national bank applicant must follow the notice requirements in the applicable statute.

A national bank applicant in a Section 1206 Merger *resulting in a national bank* would be required to follow the notice requirements of 12 U.S.C. 215a. A national bank applicant in a Section 1206 Merger *resulting in a nonbank affiliate* would be required to follow the notice requirements of 12 U.S.C. 214a. We proposed to amend § 5.33(f)(1) by adding references to the special procedures to be followed in Section 1206 Mergers. We did not receive any comments on the foregoing provisions and, therefore, we adopt them as proposed.

In addition, we proposed to state in § 5.33(f)(1) that §§ 5.10 (regarding public comments) and 5.11 (regarding requests for hearings) are not applicable as a general rule to Section 1206 Mergers. However, we also reserved the discretion to determine that some or all of the provisions in § 5.10 and § 5.11 apply in a Section 1206 Merger if an application presents significant and novel policy, supervisory, or legal issues.

A few commenters urged the OCC to make the provisions in §§ 5.10 and 5.11 applicable to all Section 1206 Mergers either because this type of merger is unprecedented and likely to raise many important issues or because these mergers would result in arbitrary or uneven application of the Community Reinvestment Act (CRA)<sup>9</sup> and fair lending laws. For several reasons we decline to adopt the commenters' suggestion to impose a notice requirement in every Section 1206 Merger. First, if an insured national bank is involved in the merger, FDIC approval is required under the Bank Merger Act.<sup>10</sup> That approval requires publication of notice and provides for public comment. Second, where the national bank involved in the merger is uninsured, such as a trust bank, the OCC may determine on a case-by-case basis that an application presents significant and novel policy, supervisory, or legal issues and that public notice is, therefore, warranted. This standard covers the situations identified by commenters as appropriate for notice and hearings. Evaluating the need for public notice, or a hearing, on a case-by-case basis also avoids unnecessary burdens. In addition, we note that CRA is not applicable to transactions where no deposit facility is being acquired. Therefore, we decline the commenters' suggestion to impose a notice requirement in every Section 1206 Merger.

Finally, we proposed to make two technical changes to paragraph (f)(1). The reference to paragraph (g) for mergers or consolidations with a Federal savings association would be amended to refer more specifically to paragraph (g)(2) and the reference to a resulting state bank in the parenthetical following this reference would be corrected to refer to a national bank. No comments were received on these provisions. For the reasons discussed above, we adopt § 5.33(f) as proposed.

The proposal also added a new § 5.33(g)(4) to address Section 1206 Mergers of national banks with their nonbank affiliates when the resulting entity is a national bank. Section 5.33(g)(4)(i) stated that a na-

<sup>9</sup> 12 U.S.C. 2901 *et seq.*

<sup>10</sup> 12 U.S.C. 1828(c).

tional bank may enter into this type of Section 1206 Merger when the law of the state or other jurisdiction under which the nonbank affiliate is organized allows the nonbank affiliate to engage in such mergers. This section also required a national bank to obtain the OCC's approval.

One commenter suggested that we modify the regulation to specify that a merger between an insured national bank and its nonbank affiliate must receive prior approval by the FDIC. As noted above, if the national bank involved is insured, the transaction is also subject to approval by the FDIC under the Bank Merger Act. For purposes of clarification, we have added this language to the final rule. In addition, we have also added language stating that in determining whether to approve a merger under this section, the OCC will consider the purpose of the transaction, its impact on the safety and soundness of the bank, and any effect on the bank's customers. The OCC may deny the merger if it would have a negative effect on any of these factors.

A few commenters questioned the OCC's decision to condition the merger of a nonbank affiliate on whether the law of the state or other jurisdiction under which the affiliate is organized permits the affiliate to participate in such a merger. These commenters contended that there is no such requirement in the statute and that this condition encourages states to discriminate against national banks by enacting laws that prohibit this type of merger. One commenter suggested that this requirement be revised to permit the merger where the state's law permits a merger between the nonbank affiliate and any other body corporate. We believe the language of the proposal as drafted already achieves this result. The proposal required only that the state statute permit such a merger. As long as this is the case, the state statute providing merger authority need not specifically mention national banks. For these reasons, the state law provision is retained in the final rule.

Proposed § 5.33(g)(4)(ii) stated that a national bank entering into such a merger must follow the procedures and requirements contained in 12 U.S.C. 215a (which addresses the merger of state banks into national banks), as if the nonbank entity were a state bank. The proposal applied the procedures and requirements in 12 U.S.C. 215a because section 215a addresses the same issues that arise in a Section 1206 Merger and its requirements are familiar to national banks. In addition, we believe that these procedures and requirements impose the least amount of burden on the participants consistent with our supervisory objectives in reviewing the proposed transactions. We received no comments on this provision and, therefore, adopt it as proposed.

Proposed § 5.33(g)(4)(iii) stated that a nonbank affiliate entering into such a merger is to follow the procedures in the law of the state or other jurisdiction under which the nonbank entity is organized. Two commenters disagreed with the use of state law procedures for mergers of a nonbank affiliate into a national bank. One commenter contended that there is no such requirement in the statute and that it has the effect of requiring the national bank to follow both state and Federal law, which may be in conflict. We note, however, that in a merger of a state bank into a national bank, the state bank follows the procedures

for mergers in state law. Proposed § 5.33(g)(4)(iii) simply treats nonbank affiliates the same as state banks by requiring them to follow the procedures contained in the law of the state in which they are incorporated. We believe that this similarity of treatment is appropriate and, therefore, have adopted this provision as proposed.

Proposed § 5.33(g)(4)(iv) stated that the rights of dissenting shareholders and appraisal of dissenters' shares of stock in the nonbank entity shall be determined in accordance with the laws of the state or other jurisdiction under which the nonbank entity is organized. We received no comments suggesting changes to this section of the proposed rule and have, therefore, adopted it as proposed.

Proposed § 5.33(g)(4)(v) of the proposal stated that the corporate existence of each institution participating in the merger shall be continued in the resulting national bank, and all the rights, franchises, property, appointments, liabilities, and other interests of the participating institutions shall be transferred to the resulting national bank in the same manner and to the same extent as in a merger between a national bank and a state bank under 12 U.S.C. 215a, as if the nonbank affiliate were a state bank. A few commenters suggested that this provision state that a national bank resulting from a merger with a nonbank affiliate may not exercise any power or engage in any activity that would not be permissible for a national bank under applicable provisions of Federal law other than section 215a-3. We note that this language is already set forth specifically in the statute at 12 U.S.C. 215a-3(b)(2). In addition, current § 5.33(e)(5) states that the OCC generally requires a national bank to discontinue nonconforming activities within a reasonable time following a business combination. This provision would be applicable to transactions under § 5.33(g)(4). Because the statute and our rules already address this point, we believe no further clarification is required, and we have adopted the provision as proposed.

The proposal also added a new § 5.33(g)(5), which addressed section 1206 Mergers of uninsured national banks with their nonbank affiliates when the resulting entity is a nonbank affiliate. The proposal limited this type of section 1206 Merger to national banks that are not insured banks (as defined in 12 U.S.C. 1813(h)). Prior to the enactment of section 1206, there was no efficient way for a national bank to cease its deposit-taking business, surrender its charter, and combine its business with that of an affiliate because no statutory provisions addressed this type of transaction. The section 1206 authority allows this transaction to take place in a merger and therefore allows the OCC to establish the procedures necessary when an uninsured national bank wishes to surrender its national charter but continue conducting lines of business that are authorized for the nonbank affiliate.

Proposed § 5.33(g)(5)(i) stated that this type of section 1206 Merger may be entered into when the law of the state or other jurisdiction under which the nonbank affiliate is organized allows such mergers. It also provided that an uninsured national bank must obtain the OCC's approval for the transaction. As was done in § 5.33(g)(4)(i), we have added language to the final rule in § 5.33(g)(5)(i) stating that the OCC will consider the purpose of the transaction, its impact on

the safety and soundness of the bank, and any effect on the bank's customers. The OCC may deny the merger if it would have a negative effect on any of these factors.

Proposed § 5.33(g)(5)(ii) stated that a national bank entering into such a merger shall follow the procedures and requirements contained in 12 U.S.C. 214a (which addresses the merger of national banks into state banks), as if the nonbank entity were a state bank. Section 5.33(g)(5)(iii) stated that a nonbank affiliate entering into such a merger shall follow the procedures and requirements in the law of the state or other jurisdiction under which the nonbank entity is organized. Section 5.33(g)(5)(iv) of the proposal stated that dissenting national bank shareholders may receive in cash the value of their national bank shares if they comply with the requirements of 12 U.S.C. 214a as if the nonbank affiliate were a state bank. That section also stated that the OCC may conduct an appraisal or reappraisal of dissenters' shares of stock in a national bank involved in a merger with a nonbank affiliate that results in a nonbank affiliate if all parties agree that the determination is final and binding on each party and agree on how the OCC's expenses relating to the appraisal will be divided among the parties and paid to the OCC. The proposal provided that rights of dissenting shareholders and appraisal of dissenters' shares of stock in the nonbank entity shall be determined in accordance with the laws of the state or other jurisdiction under which the nonbank entity is organized. We received no comments on these provisions and adopt them as proposed.

Proposed § 5.33(g)(5)(v) stated that the corporate existence of each entity participating in the merger shall be continued in the resulting nonbank affiliate, and all the rights, franchises, property, appointments, liabilities, and other interests of the participating national bank shall be transferred to the resulting nonbank affiliate as set forth in 12 U.S.C. 214b, in the same manner and to the same extent as in a merger between a national bank and a state bank under 12 U.S.C. 214a, as if the nonbank affiliate were a state bank. A number of commenters suggested that we clarify that where the surviving entity is a nonbank affiliate, it does not succeed to any of the powers of the national bank, and that the national bank and its powers cease to exist. We agree that a national bank ceases to exist following consummation of a section 1206 Merger and that a surviving nonbank affiliate will not be permitted to exercise powers of the former national bank except to the extent permitted under state law or other law applicable to the resulting nonbank affiliate. The wording of the regulation does not say otherwise, however and in our view it is important to be clear that the surviving nonbank affiliate does enjoy corporate succession to the corporate rights, franchises, property, appointments, liabilities, and other interests of the former national bank. This is the same result as when a national bank merges into a state bank under 12 U.S.C. 214a and 214b. We do not believe that any change to the regulation is necessary by virtue of these comments and adopt this provision as proposed.

Finally, the proposal added a new paragraph (j)(1)(iv) to § 5.33 that permits applications for certain transactions under § 5.33(g)(4) to receive streamlined

treatment. In order to qualify for such treatment, the acquiring bank must be an eligible bank, the resulting national bank must be well capitalized immediately following consummation of the transaction, the applicants in a pre-filing communication must request and obtain approval from the appropriate district office to use the streamlined application, and the total assets acquired in the transaction must not exceed 10 percent of the total assets of the acquiring national bank, as reported in the bank's Consolidated Report of Condition and Income filed for the quarter immediately preceding the filing of the application. We received no comments on this provision and adopt it as proposed.

### 3. National Bank Directors—§ 7.2024 (new)

Section 1205 of the AHEOA amended section 5145 of the Revised Statutes of the United States (12 U.S.C. 71) and section 31 of the Banking Act of 1933 (12 U.S.C. 71a) regarding national bank directors. Section 1205 increases the maximum term a director may serve from one to not more than three years and permits a national bank to adopt bylaws that provide for staggering the terms of its directors in accordance with the OCC's regulations. In addition, this section permits the OCC to exempt a national bank from the otherwise applicable requirement that it have no more than 25 directors.

The proposal added a new § 7.2024 conforming the OCC's rules to these provisions. Pursuant to proposed § 7.2024(a), national banks may adopt bylaws that provide for staggering the terms of their directors. Proposed § 7.2024(b) increased the permissible maximum term of national bank directors from one year to three years. Finally, paragraph (c) provided that a national bank may increase the size of its board of directors above the statutory limit of 25 provided that the bank satisfies the notice requirements set out in that section. We received two comments on this provision, both of which supported the proposal. Accordingly, we adopt it as proposed.

## II. Additional Changes to Parts 5, 7, 9, and 34

### A. Part 5 Amendments

The final rule also revised three other provisions in part 5 of our regulations. Section 5.20 of our regulations contains the requirements that govern the organization of a national bank. The proposal amended § 5.20(e)(1) to provide that the newly organized bank may be a special purpose national bank that limits its activities to fiduciary activities or to any other activities within the business of banking. The purpose of this proposed change was to clarify that a limited purpose national bank may exist with respect to activities other than fiduciary activities, provided the activities in question are part of the business of banking. Some commenters expressed concern that this provision was too broad and that the expansion of the limited purpose charter had the potential to exclude from state oversight entities conducting activities only loosely related to banking. We agree that it is appropriate to provide further clarification of the scope of activities permissible for a limited purpose national bank, and we have amended this provision to require limited purpose national banks to conduct at least one of the following core banking functions: (1)



Receiving deposits; (2) paying checks; or (3) lending money. These functions are based on 12 U.S.C. 36, which identifies activities that cause a facility to be considered a bank branch.

Section 5.33(e) of our regulations contains a listing of factors the OCC considers in evaluating applications for business combinations. These factors are based upon the factors set forth in the Bank Merger Act and the CRA. As part of the USA PATRIOT Act,<sup>11</sup> Congress amended the Bank Merger Act by adding a factor to be considered in evaluating merger transactions. This factor requires the responsible agencies to consider the effectiveness of any insured depository institution involved in a proposed merger in combating money laundering activities.<sup>12</sup> The proposal conformed our regulations with the statute by adding the factor at § 5.33(e)(1)(v).

Finally, current § 5.34(e)(5)(iv) permits certain national banks to acquire or establish an operating subsidiary or perform a new activity in an existing operating subsidiary by providing after-the-fact notice to the OCC if the operating subsidiary conducts certain activities listed in § 5.34(e)(5)(v). That list currently includes the underwriting of credit-related insurance consistent with section 302 of the Gramm-Leach-Bliley Act. Since the list was last revised, the OCC has determined, in Corporate Decision 2001-10 (April 23, 2001) and Corporate Decision 2000-16 (August 29, 2000), that credit-related reinsurance products satisfy GLBA section 302's statutory requirements and are "authorized products." The proposal therefore amended 12 CFR 5.34(e)(5)(v)(L) to add reinsuring of credit-related insurance to the list of activities eligible for after-the-fact notice requirements.

We received no comments on these proposed changes to §§ 5.33(e) or 5.34(e) and therefore adopt these changes as proposed.

#### B. Part 7 Amendment

As corporate transactions have become more sophisticated, an integral part of financial and transactional advice with respect to mergers and other corporate restructurings inevitably involves providing advice on the tax implications of those transactions. Recently amended § 5.34(e)(5)(v)(J) and (K) permit national banks to provide tax planning services and to provide financial and transactional advice on structuring, arranging, and executing financial transactions, including mergers, acquisitions, and divestitures. Providing tax planning services encompasses tax consulting in order for a bank to be able to offer comprehensive services in this area. Accordingly, the proposal deleted as outdated the prohibition against serving as an expert tax consultant that currently appears at § 7.1008.<sup>13</sup> We received no comments re-

garding this change, and therefore adopt it as proposed.

#### C. Part 9 Amendment

Currently, 12 CFR 9.18(b)(4)(i) requires valuation of collective investment funds at least every three months. However, certain funds are only required to be valued once a year. Those funds must be "(a)(2) funds" (i.e., funds that may be held pursuant to 12 CFR 9.18(a)(2) that are primarily invested in real estate or other assets that are not readily marketable). A growing number of collective investment funds, including (a)(1) funds, however, are comprised of a mix of assets that are readily marketable and assets that are not readily marketable. Those funds do not qualify for the one-year valuation because they are not (a)(2) funds primarily invested in real estate or other assets that are not readily marketable. However, a one-year valuation may be appropriate for assets in those funds that are not readily marketable. Thus, we proposed to amend the regulation to require quarterly valuation of readily marketable assets in all collective investment funds, including (a)(1) funds. Assets that are not readily marketable must be valued at least once a year regardless of whether the assets are in (a)(1) or (a)(2) funds or whether the funds' assets are primarily invested in real estate or other assets that are not readily marketable. For purposes of an admission or withdrawal date, this provision does not negate the need to provide a current value at the time of such admission or withdrawal. We received no comments regarding this change, and therefore adopt it as proposed.

#### D. Part 34 Amendment

Section 34.3 restates the comprehensive authority vested in the OCC by 12 U.S.C. 371 to regulate real estate lending by national banks. Section 371 authorizes national banks to engage in real estate lending subject to 12 U.S.C. 1828(o) (real estate lending safety and soundness standards) and "such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order." The cross-reference to 12 U.S.C. 1828(o) was added to the statute in 1991, but the text of the regulation was never revised to reflect it. Thus, the proposal updated the regulation to reflect that change to the underlying statute. Other portions of the regulation remain unchanged.<sup>14</sup> We received no comments regarding this change, and therefore adopt it as proposed.

### III. Technical Amendments

The proposal contained the following technical amendments:

- 12 CFR part 3, appendix A, section 3(a)(2)(ix) currently cross-references a definition of "General obligation of a State or political subdivision"

<sup>11</sup> Pub. L. 107-56, 115 Stat. 272 (Oct. 26, 2001).

<sup>12</sup> The FDIC recently updated its Statement of Policy on Bank Merger Transactions to include this new factor at 67 FR 48178 (July 23, 2002). This update only provides the new provision. The complete Policy Statement as it existed before this update may be found at 63 FR 44761 (August 20, 1998).

<sup>13</sup> National banks engaged in providing the services permitted by 12 CFR 5.34(e)(5)(v)(J) and (K) must comply with applicable

regulations of the Internal Revenue Service (IRS) governing the provision of such services. Information about the IRS regulations may be obtained at <http://www.irs.treas.gov>.

<sup>14</sup> We have proposed additional changes to part 34 in a separate rulemaking that invites comment on changes to the provisions governing preemption. See 68 FR 46119 (Aug. 5, 2003). The comment period for that rulemaking closed October 6, 2003.



but contains the wrong regulatory citation for that definition. The definition in question has been moved from 12 CFR 1.3(g) to 12 CFR 1.2(b). The proposed revision corrected the citation. Also in part 3 appendix A, section 4(a)(11)(ii), the references to section 4(a)(8)(i) and (ii) were corrected to refer to section 4(a)(9)(i) and (ii), respectively.

- The citations to FDIC regulations in current 12 CFR 6.4(c)(1)(i) and (ii) are incorrect. The proposal amended the citations to correct them.
- Current 12 CFR 7.1016(a) contains a footnote reference and accompanying footnote text. The footnote reference number is 30, but should be 1. The proposal made this change.
- Current 12 CFR 9.20(b) contains a reference to SEC rules 17 CFR 240.17Ad-1 through 240.17Ad-16. A new rule, at 17 CFR 240.17Ad-17, has been added, so the proposal changed the reference to 240.17Ad-16 to reflect the addition.
- Current 12 CFR 28.16(e), dealing with uninsured deposit notices, makes a reference to an FDIC regulation, 12 CFR 346.7, which was removed in 1998. The proposal corrected this citation to refer to the current rule for uninsured deposit notices, which can now be found at 12 CFR 347.207.

We received no comments regarding these changes, and therefore adopt them as proposed.

#### IV. Regulatory Analysis

##### *CDRI Act Delayed Effective Date*

This final rule takes effect 30 days after the date of its publication in the **Federal Register**, consistent with the delayed effective date requirement of the Administrative Procedure Act. See 5 U.S.C. 553(d). Section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI Act), 12 U.S.C. 4802(b), provides that regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions may not take effect before the first day of the quarter following publication unless the agency finds that there is good cause to make the rule effective at an earlier date. The regulations in this final rule provide procedures to be used by national banks wishing to take advantage of the new transactions or corporate governance options permitted by the AHEOA. The regulations make it easier for national banks to exercise this new statutory authority. Accordingly, the OCC finds that there is good cause to dispense with the requirements of the CDRI Act.

##### *Regulatory Flexibility Act*

Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b) (RFA), the regulatory flexibility analysis otherwise required under section 604 of the RFA is not required if the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities and publishes its certification and a short, explanatory statement in the **Federal Register** along with its rule.

Pursuant to section 605(b) of the RFA, the OCC hereby certifies that this final rule will not have a

significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not needed. The amendments to the OCC's regulations relating to the AHEOA are permissive provisions that will be used only by banks that wish to take advantage of the new transactions, procedures, or corporate governance options permitted by the statute as implemented by the regulations. 12 CFR 5.33(g)(5) reduces burden by implementing a simpler way to accomplish a merger of a national bank into one of its nonbank affiliates. The amendments simply provide the OCC's implementation of the AHEOA or make other technical changes to the rules to correct existing errors or clarify various points. They do not impose any new requirements or burdens. As such, they will not result in any adverse economic impact.

##### *Executive Order 12866*

The OCC has determined that this final rule is not a significant regulatory action under Executive Order 12866.

##### *Unfunded Mandates Reform Act of 1995*

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104-4 (2 U.S.C. 1532) (Unfunded Mandates Act), requires that an agency prepare a budgetary impact statement before promulgating any rule likely to result in a Federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC has determined that this final rule will not result in expenditures by State, local, and tribal governments, or by the private sector, of \$100 million or more in any one year. Accordingly, this rulemaking is not subject to section 202 of the Unfunded Mandates Act.

##### *Paperwork Reduction Act*

The OCC may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number.

The information collection requirements in this final rule are contained in §§ 5.32, 5.33, and 7.2024.

OMB has reviewed and approved the information collection requirements under OMB Control Number 1557-0014, in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

The Comptroller's Corporate Manual (Manual) explains the OCC's policies and procedures for the formation of a new national bank, entry into the national banking system by other institutions, and corporate expansion and structural changes by existing national banks. The Manual embodies all required procedures, forms, and regulations regarding OCC corporate decisions.

The information collection requirements imposed by §§ 5.32 and 5.33 are contained in the Business

Combinations booklet in the Manual and are part of the total requirement.

The respondents are national banks.

*Estimated number of respondents:* 270.

*Estimated number of responses:* 270.

*Average hours per response:* 24.

*Estimated total burden hours:* 5,580.

The information collection requirements imposed by § 7.2024 are included in the Corporate Organization booklet in the Manual, along with several other corporate requirements.

The respondents are national banks.

*Estimated number of respondents:* 1,000.

*Estimated number of responses:* 1,000.

*Average hours per response:* .5 hour.

*Estimated total burden hours:* 500 hours.

The burden estimates represent total burden for national banks' compliance with the information collection requirements associated with corporate organization matters and business combination activities.

#### *Executive Order 13132*

Executive Order 13132 (Order) requires Federal agencies, including the OCC, to certify their compliance with that Order when they transmit to the Office of Management and Budget any draft final regulation that has Federalism implications. Under the Order, a regulation has Federalism implications if it has "substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government." In the case of a regulation that has Federalism implications and that preempts state law, the Order imposes certain consultation requirements with state and local officials; requires publication in the preamble of a Federalism summary impact statement; and requires the OCC to make available to the Director of the Office of Management and Budget any written communications submitted by state and local officials. By the terms of the Order, these requirements apply to the extent that they are practicable and permitted by law and, to that extent, must be satisfied before the OCC promulgates a final regulation. In the opinion of the OCC, this final rule does not have Federalism implications.

#### **List of Subjects**

##### *12 CFR Part 3*

Administrative practice and procedure, National banks, Reporting and recordkeeping requirements.

##### *12 CFR Part 5*

Administrative practice and procedure, National banks, Reporting and recordkeeping requirements, Securities.

##### *12 CFR Part 6*

National banks.

#### **Federal Banking Law Reports**

##### *12 CFR Part 7*

Credit, Insurance, Investments, National banks, Reporting and recordkeeping requirements, Securities, Surety bonds.

##### *12 CFR Part 9*

Estates, Investments, National banks, Reporting and recordkeeping requirements, Trusts and trustees.

##### *12 CFR Part 28*

Foreign banking, National banks, Reporting and recordkeeping requirements.

##### *12 CFR Part 34*

Mortgages, National banks, Reporting and recordkeeping requirements.

#### **Authority and Issuance**

• For the reasons set forth in the preamble, the OCC amends parts 3, 5, 6, 7, 9, 28, and 34 of chapter I of title 12 of the Code of Federal Regulations as follows:

#### **PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES**

• 1. The authority citation for part 3 continues to read as follows:

**Authority:** 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907, and 3909.

#### **Appendix A to Part 3—[Amended]**

• 2. In appendix A to part 3:

• a. In section 3, amend paragraph (a)(2)(ix) by removing "12 CFR 1.3(g)" and adding in its place "12 CFR 1.2(b)"; and

• b. In section 4, amend paragraph (a)(11)(ii) by removing, "section (4)(a)(8)(i) and (ii)" and adding in its place "section (4)(a)(9)(i) and (ii)".

\* \* \* \* \*

#### **PART 5—RULES, POLICIES, AND PROCEDURES FOR CORPORATE ACTIVITIES**

• 3. The authority citation for part 5 is revised to read as follows:

**Authority:** 12 U.S.C. 1 *et seq.*, 93a; 215a-2; 215a-3; and section 5136A of the Revised Statutes (12 U.S.C. 24a).

#### **Subpart B—Initial Activities**

4. In § 5.20, add new second and third sentences to paragraph (e)(1) to read as follows:

#### **§ 5.20 Organizing a bank.**

\* \* \* \* \*

(e) *Statutory requirements*—(1) *General.* \* \* \* The bank may be a special purpose bank that limits its activities to fiduciary activities or to any other activities within the business of banking. A special purpose bank that conducts activities other than fiduciary activities must conduct at least one of the following

three core banking functions: receiving deposits; paying checks; or lending money. \* \* \*

\* \* \* \* \*

### Subpart C—Expansion of Activities

• 5. Add a new § 5.32 to Subpart C to read as follows:

#### § 5.32 Expedited procedures for certain reorganizations.

(a) *Authority.* 12 U.S.C. 93a and 215a-2.

(b) *Scope.* This section prescribes the procedures for OCC review and approval of a national bank's reorganization to become a subsidiary of a bank holding company or a company that will, upon consummation of such reorganization, become a bank holding company. For purposes of this section, a "bank holding company" means any company that owns or controls a national bank, or will own or control one as a result of the reorganization.

(c) *Licensing requirements.* A national bank shall submit an application to, and obtain approval from, the OCC prior to participating in a reorganization described in paragraph (b) of this section.

(d) *Procedures.*—(1) *General.* An application filed in accordance with this section shall be deemed approved on the 30th day after the OCC receives the application, unless the OCC notifies the bank otherwise. Approval is subject to the condition that the bank provide the OCC with 60 days' prior notice of any significant deviation from the bank's business plan or any significant deviation from the proposed changes to the bank's business plan described in the bank's plan of reorganization.

(2) *Reorganization plan.* The application must include a reorganization plan that:

(i) Specifies the manner in which the reorganization shall be carried out;

(ii) Is approved by a majority of the entire board of directors of the national bank;

(iii) Specifies:

(A) The amount and type of consideration that the bank holding company will provide to the shareholders of the reorganizing bank for their shares of stock of the bank;

(B) The date as of which the rights of each shareholder to participate in that exchange will be determined; and

(C) The manner in which the exchange will be carried out;

(iv) Is submitted to the shareholders of the reorganizing bank at a meeting to be held at the call of the directors in accordance with the procedures prescribed in connection with a merger of a national bank under section 3 of the National Bank Consolidation and Merger Act, 12 U.S.C. 215a(a)(2); and

(v) Describes any changes to the bank's business plan resulting from the reorganization.

(3) *Financial and managerial resources and future prospects.* In reviewing an application under this sec-

tion, the OCC will consider the impact of the proposed affiliation on the financial and managerial resources and future prospects of the national bank.

(e) *Rights of dissenting shareholders.* Any shareholder of a bank who has voted against an approved reorganization at the meeting referred to in paragraph (d)(2)(iv) of this section, or who has given notice of dissent in writing to the presiding officer at or prior to that meeting, is entitled to receive the value of his or her shares by providing a written request to the bank within 30 days after the consummation of the reorganization, as provided by section 3 of the National Bank Consolidation and Merger Act, 12 U.S.C. 215a(b) and (c), for the merger of a national bank.

(f) *Approval under the Bank Holding Company Act.* This section does not affect the applicability of the Bank Holding Company Act of 1956. Applicants shall indicate in their application the status of any application required to be filed with the Board of Governors of the Federal Reserve System.

(g) *Expiration of approval.* Approval expires if a national bank has not completed the reorganization within one year of the date of approval.

(h) *Adequacy of disclosure.* (1) An applicant shall inform shareholders of all material aspects of a reorganization and comply with applicable requirements of the Federal securities laws, including the OCC's securities regulations at 12 CFR part 11.

(2) Any applicant not subject to the registration provisions of the Securities Exchange Act of 1934 shall submit the proxy materials or information statements it uses in connection with the reorganization to the appropriate district office no later than when the materials are sent to the shareholders.

• 6. In § 5.33:

• a. revise paragraph (a);

• b. paragraph (b) is redesignated as paragraph (c), paragraph (c) is redesignated as paragraph (b), newly redesignated paragraph (b) is revised and a sentence is added at the end of newly redesignated paragraph (c);

• c. paragraphs (d)(1), (d)(2), (d)(3), and (d)(4) are redesignated as paragraphs (d)(2), (d)(3), (d)(6), and (d)(7), respectively; revise newly designated paragraph (d)(2); and add new paragraphs (d)(1), (d)(4), (d)(5), and (d)(8);

• d. add new paragraph (e)(1)(v);

• e. revise paragraph (e)(3)(ii);

• f. revise the second sentence of paragraph (f)(1) and add two new sentences at the end of the paragraph;

• g. add new paragraphs (g)(4) and (g)(5);

• h. at the end of paragraph (j)(1)(ii), remove the term "or";

• i. at the end of paragraph (j)(1)(iii), remove "." and add "; or"; and

• j. add new paragraph (j)(1)(iv) to read as follows:

**§5.33 Business combinations.**

(a) *Authority.* 12 U.S.C. 24(Seventh), 93a, 181, 214a, 214b, 215, 215a, 215a-1, 215a-3, 215c, 1815(d)(3), 1828(c), 1831u, and 2903.

(b) *Scope.* This section sets forth the provisions governing business combinations and the standards for:

(1) OCC review and approval of an application for a business combination between a national bank and another depository institution resulting in a national bank or between a national bank and one of its nonbank affiliates; and

(2) Requirements of notices and other procedures for national banks involved in other combinations with depository institutions.

(c) *Licensing requirements.* \* \* \* A national bank shall submit an application and obtain prior OCC approval for any merger between the national bank and one or more of its nonbank affiliates.

(d) *Definitions.* (1) *Bank* means any national bank or any state bank.

(2) *Business combination* means any merger or consolidation between a national bank and one or more depository institutions in which the resulting institution is a national bank, the acquisition by a national bank of all, or substantially all, of the assets of another depository institution, the assumption by a national bank of deposit liabilities of another depository institution, or a merger between a national bank and one or more of its nonbank affiliates.

\* \* \* \* \*

(4) *Company* means a corporation, limited liability company, partnership, business trust, association, or similar organization.

(5) For business combinations under §5.33(g)(4) and (5), a company or shareholder is deemed to control another company if:

(i) Such company or shareholder, directly or indirectly, or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company, or

(ii) Such company or shareholder controls in any manner the election of a majority of the directors or trustees of the other company. No company shall be deemed to own or control another company by virtue of its ownership or control of shares in a fiduciary capacity.

\* \* \* \* \*

(8) *Nonbank affiliate of a national bank* means any company (other than a bank or Federal savings association) that controls, is controlled by, or is under common control with the national bank.

(e) \* \* \*

(1) \* \* \*

(v) *Money laundering.* The OCC considers the effectiveness of any insured depository institution involved in the business combination in combating money laundering activities, including in overseas branches.

\* \* \* \* \*

(3) \* \* \*

(ii) An applicant proposing to acquire, through a business combination, a subsidiary of any entity other than a national bank must provide the same information and analysis of the subsidiary's activities that would be required if the applicant were establishing the subsidiary pursuant to § 5.34 or 5.39.

\* \* \* \* \*

(f) *Exceptions to rules of general applicability—(1) National bank applicant.* \* \* \* A national bank applicant shall follow, as applicable, the public notice requirements contained in 12 U.S.C. 1828(c)(3) (business combinations), 12 U.S.C. 215(a) (consolidation under a national bank charter), 12 U.S.C. 215a(a)(2) (merger under a national bank charter), paragraph (g)(2) of this section (merger or consolidation with a Federal savings association resulting in a national bank), paragraph (g)(4) of this section (merger with a nonbank affiliate under a national bank charter), and paragraph (g)(5) of this section (merger with nonbank affiliate not under national bank charter). Sections 5.10 and 5.11 do not apply to mergers of a national bank with its nonbank affiliate. However, if the OCC concludes that an application presents significant and novel policy, supervisory, or legal issues, the OCC may determine that some or all provisions in §§ 5.10 and 5.11 apply.

\* \* \* \* \*

(g) \* \* \*

(4) *Mergers of a national bank with its nonbank affiliates under 12 U.S.C. 215a-3 resulting in a national bank.* (i) With the approval of the OCC, a national bank may merge with one or more of its nonbank affiliates, with the national bank as the resulting institution, in accordance with the provisions of this paragraph, provided that the law of the state or other jurisdiction under which the nonbank affiliate is organized allows the nonbank affiliate to engage in such mergers. The transaction is also subject to approval by the FDIC under the Bank Merger Act, 12 U.S.C. 1828(c). In determining whether to approve the merger, the OCC shall consider the purpose of the transaction, its impact on the safety and soundness of the bank, and any effect on the bank's customers, and may deny the merger if it would have a negative effect in any such respect.

(ii) A national bank entering into the merger shall follow the procedures of 12 U.S.C. 215a as if the nonbank affiliate were a state bank, except as otherwise provided herein.

(iii) A nonbank affiliate entering into the merger shall follow the procedures for such mergers set out in the law of the state or other jurisdiction under which the nonbank affiliate is organized.

(iv) The rights of dissenting shareholders and appraisal of dissenters' shares of stock in the nonbank affiliate entering into the merger shall be determined in the manner prescribed by the law of the state or other jurisdiction under which the nonbank affiliate is organized.

(v) The corporate existence of each institution participating in the merger shall be continued in the

resulting national bank, and all the rights, franchises, property, appointments, liabilities, and other interests of the participating institutions shall be transferred to the resulting national bank, as set forth in 12 U.S.C. 215a(a), (e), and (f) in the same manner and to the same extent as in a merger between a national bank and a state bank under 12 U.S.C. 215a(a), as if the nonbank affiliate were a state bank.

(5) *Mergers of an uninsured national bank with its nonbank affiliates under 12 U.S.C. 215a-3 resulting in a nonbank affiliate.* (i) With the approval of the OCC, a national bank that is not an insured bank as defined in 12 U.S.C. 1813(h) may merge with one or more of its nonbank affiliates, with the nonbank affiliate as the resulting entity, in accordance with the provisions of this paragraph, provided that the law of the state or other jurisdiction under which the nonbank affiliate is organized allows the nonbank affiliate to engage in such mergers. In determining whether to approve the merger, the OCC shall consider the purpose of the transaction, its impact on the safety and soundness of the bank, and any effect on the bank's customers, and may deny the merger if it would have a negative effect in any such respect.

(ii) A national bank entering into the merger shall follow the procedures of 12 U.S.C. 214a, as if the nonbank affiliate were a state bank, except as otherwise provided in this section.

(iii) A nonbank affiliate entering into the merger shall follow the procedures for such mergers set out in the law of the state or other jurisdiction under which the nonbank affiliate is organized.

(iv) (A) National bank shareholders who dissent from an approved plan to merge may receive in cash the value of their national bank shares if they comply with the requirements of 12 U.S.C. 214a as if the nonbank affiliate were a state bank. The OCC may conduct an appraisal or reappraisal of dissenters' shares of stock in a national bank involved in the merger if all parties agree that the determination is final and binding on each party and agree on how the total expenses of the OCC in making the appraisal will be divided among the parties and paid to the OCC.

(B) The rights of dissenting shareholders and appraisal of dissenters' shares of stock in the nonbank affiliate involved in the merger shall be determined in the manner prescribed by the law of the state or other jurisdiction under which the nonbank affiliate is organized.

(v) The corporate existence of each entity participating in the merger shall be continued in the resulting nonbank affiliate, and all the rights, franchises, property, appointments, liabilities, and other interests of the participating national bank shall be transferred to the resulting nonbank affiliate as set forth in 12 U.S.C. 214b, in the same manner and to the same extent as in a merger between a national bank and a state bank under 12 U.S.C. 214a, as if the nonbank affiliate were a state bank.

\* \* \* \* \*

(j) \* \* \*

(l) \* \* \*

(iv) In the case of a transaction under paragraph (g)(4) of this section, the acquiring bank is an eligible bank, the resulting national bank will be well capitalized immediately following consummation of the transaction, the applicants in a prefling communication request and obtain approval from the appropriate district office to use the streamlined application, and the total assets acquired do not exceed 10 percent of the total assets of the acquiring national bank, as reported in the bank's Consolidated Report of Condition and Income filed for the quarter immediately preceding the filing of the application.

\* \* \* \* \*

• 7. In 5.34, revise paragraph (e)(5)(v)(L) to read as follows:

#### § 5.34 Operating subsidiaries.

\* \* \* \* \*

(e) \* \* \*

(5) \* \* \*

(v) \* \* \*

(L) Underwriting and reinsuring credit related insurance to the extent permitted under section 302 of the GLBA (15 U.S.C. 6712);

\* \* \* \* \*

#### PART 6—PROMPT CORRECTIVE ACTION

• 8. The authority citation for part 6 continues to read as follows:

**Authority:** 12 U.S.C. 93a, 1831o.

#### Subpart A—Capital Categories

• 9. In § 6.4, revise paragraphs (c)(1)(i) and (ii) to read as follows:

#### § 6.4 Capital measures and capital category definitions.

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(i) Maintains the pledge of assets required under 12 CFR 347.210; and

(ii) Maintains the eligible assets prescribed under 12 CFR 347.211 at 108 percent or more of the preceding quarter's average book value of the insured branch's third-party liabilities; and

\* \* \* \* \*

#### PART 7—BANK ACTIVITIES AND OPERATIONS

• 10. Revise the authority citation for part 7 to read as follows:

**Authority:** 12 U.S.C. 1 *et seq.*, 71, 71a, 92, 92a, 93, 93a, 481, 484, 1818.

#### Subpart A—Bank Powers

• 11. Revise § 7.1008 to read as follows:

**§ 7.1008 Preparing income tax returns for customers or public.**

A national bank may assist its customers in preparing their tax returns, either gratuitously or for a fee.

**§ 7.1016 [Amended]**

- 12. In § 7.1016(a), redesignate footnote 30 as footnote 1.

**Subpart B—Corporate Practices**

- 13. Add a new § 7.2024 to read as follows:

**§ 7.2024 Staggered terms for national bank directors and size of bank board.**

(a) *Staggered terms.* Any national bank may adopt bylaws that provide for staggering the terms of its directors. National banks shall provide the OCC with copies of any bylaws so amended.

(b) *Maximum term.* Any national bank director may hold office for a term that does not exceed three years.

(c) *Number of directors.* A national bank's board of directors shall consist of no fewer than 5 and no more than 25 members. A national bank may, after notice to the OCC, increase the size of its board of directors above the 25 member limit. A national bank seeking to increase the number of its directors must notify the OCC any time the proposed size would exceed 25 directors. The bank's notice shall specify the reason(s) for the increase in the size of the board of directors beyond the statutory limit.

**PART 9—FIDUCIARY ACTIVITIES OF NATIONAL BANKS**

- 15. The authority citation for part 9 continues to read as follows:

**Authority:** 12 U.S.C. 24 (Seventh), 92a, and 93a; 15 U.S.C. 78q, 78q-1, and 78w.

- 16. In § 9.18, revise paragraph (b)(4)(i) to read as follows:

**§ 9.18 Collective investment funds.**

\* \* \* \* \*

(b) \* \* \*

(4) *Valuation—(i) Frequency of valuation.* A bank administering a collective investment fund shall determine the value of the fund's readily marketable assets at least once every three months. A bank shall determine the value of the fund's assets that are not readily marketable at least once a year.

\* \* \* \* \*

- 17. In § 9.20, amend paragraph (b), by removing the term "240.17Ad-16" and adding in its place the term "240.17Ad-17."

**PART 28—INTERNATIONAL BANKING ACTIVITIES**

- 18. The authority citation for part 28 continues to read as follows:

**Authority:** 12 U.S.C. 1 *et seq.*, 24 (Seventh), 93a, 161, 602, 1818, 3101 *et seq.*, and 3901 *et seq.*

**Subpart B—Federal Branches and Agencies of Foreign Banks**

- 19. In § 28.16, amend paragraph (e), by removing the term "12 CFR 346.7" and adding in its place the term "12 CFR 347.207."

**PART 34—REAL ESTATE LENDING AND APPRAISALS****Subpart A—General**

- 20. The authority citation for part 34 continues to read as follows:

**Authority:** 12 U.S.C. 1 *et seq.*, 29, 93a, 371, 1701j-3, 1828(o), and 3331 *et seq.*

- 21. Revise § 34.3 to read as follows:

**§ 34.3 General rule.**

A national bank may make, arrange, purchase, or sell loans or extensions of credit, or interests therein, that are secured by liens on, or interests in, real estate (real estate loans), subject to 12 U.S.C. 1828(o) and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order.

Dated: October 17, 2003.

**John D. Hawke, Jr.,**

*Comptroller of the Currency.*

**¶ 93-734 FDIC Warns of Deceptive Claims of FDIC Insurance Coverage.**

Federal Deposit Insurance Corporation. SA-80-2003, December 16, 2003. Alert in full text.

See ¶ 8154.

[SA -80-2003]

TO: CHIEF EXECUTIVE OFFICER (also may be of interest to Security Officer)

SUBJECT: Deceptive Claims of FDIC Insurance Coverage

Summary:

*An entity is falsely representing on its Web site that it is a member of the FDIC. The entity, located in New*

*York, New York, may be referred to by multiple names, including Effex Bank, NA; Effex Bank Ltd; Effexbank Bank, Ltd; or Effexbank International Bank Limited.*

Please be advised that the Federal Deposit Insurance Corporation (FDIC) was recently notified an entity may be operating a banking business without authorization and is unlawfully advertising FDIC membership on its Internet Web site. The entity may be referred to by multiple names, including Effex Bank, NA; Effex Bank Ltd; Effexbank Bank, Ltd; or Effexbank International Bank Limited. According to

Federal Banking Law Reports

¶ 93-734



---

**DEPARTMENT OF THE TREASURY**

**Office of the Comptroller of the  
Currency**

**12 CFR Part 5**

**[Docket No. 04-02]**

**RIN 1557-AC11**

**Fundamental Change in Asset  
Composition of a Bank**

**AGENCY:** Office of the Comptroller of the  
Currency, Treasury.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Office of the Comptroller of the Currency (OCC) is proposing to amend its regulations to require a national bank to obtain the approval of the OCC before two types of fundamental changes in the composition of the bank's assets: (1) Changing the composition of all, or substantially all, of its assets through sales or other dispositions or, (2) after having sold or disposed of all or substantially all of its assets, subsequently purchasing or otherwise acquiring assets. The proposal also provides that, in the second case, the OCC will apply, among other factors,



the same factors as it applies to the establishment of a *de novo* bank. This new approval requirement will enable the OCC to better assess the bank's compliance with applicable law and safe and sound banking practices.

**DATES:** Comments must be received by March 8, 2004.

**ADDRESSES:** Please send your comments to: Office of the Comptroller of the Currency, Public Information Room, 250 E Street, SW., Mail Stop 1-5, Washington, DC 20219, Attention: Docket No. 04-02. Due to delays in paper mail delivery in the Washington, DC area, commenters are encouraged to submit their comments by fax or e-mail. You may fax your comments to (202) 874-4448 or electronic mail them to [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

Comments may be inspected and photocopied at the OCC's Public Information Room, 250 E Street, and SW., Washington, DC. You can make an appointment to inspect and photocopy comments by calling (202)-874-5043.

**FOR FURTHER INFORMATION CONTACT:** Heidi M. Thomas, Special Counsel, Legislative and Regulatory Activities, at (202) 874-5090; or Jan Kalmus, NBE/Licensing Expert, Licensing Policy and Systems, at (202) 874-5060.

#### **SUPPLEMENTARY INFORMATION:**

##### **I. Background**

A national bank that divests itself of assets through sale or other disposition to become a "stripped" or "dormant" bank charter, or, having "stripped down," subsequently takes on new assets through purchases or acquisitions, raises significant supervisory concerns. These concerns include increased operations risk, increased concentration risk (especially where asset composition changes as a result of divestiture), and the ability of bank management to implement the new strategy successfully. In addition, the dormant bank being revived may propose to engage in activities that significantly deviate or are a change from the bank's original business plan or operations.<sup>1</sup> Ill-conceived, poorly

planned, or inadequately executed changes in a national bank's business can expose the bank to imprudent levels of risk, with the potential for adverse consequences for the bank's financial condition and, in the extreme situation, for its viability.<sup>2</sup> Even entry into lines of business that are traditional for national banks may present elevated levels of risk to a particular bank if the bank expands too quickly from a dormant status, misjudges its markets, or fails to ensure that bank management and internal control systems keep pace with the change. Moreover, the acquisition of a dormant charter by a third party raises concerns about the need to thoroughly review the nature of the services and products that might be initiated by an acquiring entity.

Our current regulations do not require the approval of the OCC before a bank "strips down" to a dormant bank charter, nor do they require our approval when a dormant bank increases its asset size to engage again in the business of banking. To better assess the bank's compliance with applicable law and safe and sound banking practices, we are proposing to amend our regulations to require prior OCC approval for two types of fundamental changes in the composition of a national bank's assets: (1) A change in composition of all or substantially all of a bank's assets resulting from a sale or other disposition of the bank's assets, or (2) an increase in the asset size of a national bank that had previously "stripped down" in a transaction described in item (1), regardless of existing or new ownership.

In addition, because a "stripped" or dormant charter that subsequently increases in asset size fundamentally resembles a new entrant obtaining a new charter, transactions described in item (2) will be evaluated under the same standards that the OCC applies to a *de novo* national bank charter proposal.

banks, including the introduction of plans that were not previously reviewed during the chartering process with no objection by the OCC; and (7) relationships with a parent company or affiliate, such as a shift to significant reliance on a parent or affiliate as a funding source or provider of back office support. See OCC's Significant Deviation Policy, as posted as a supplemental policy document to the Charters Booklet of the Comptroller's Licensing Manual, <http://www.occ.treas.gov/corpbok/forms/SigDevPolicy8-03.pdf>.

<sup>2</sup> In the past few years, for example, some national banks have materially changed the general character of their business by shifting to a concentration of subprime loans or relying on technology-based product and service delivery systems. In some cases, the safety and soundness of these banks was adversely affected because bank management did not fully understand or effectively control the risks associated with the changes.

##### **II. Description of the Proposal**

**Approval requirements.** This proposal would add a new § 5.53 to subpart D of 12 CFR part 5. Proposed § 5.53(c) requires that a national bank obtain the OCC's prior written approval before changing the composition of all, or substantially all, of its assets through (1) sales or other disposition or, (2) after having sold or disposed of all or substantially all of its assets, through purchases or other acquisitions. A bank that has disposed of all or substantially all of its assets before the effective date of this regulation must comply with the prior approval requirement if it purchases or otherwise acquires or takes on new assets after the regulation takes effect. Proposed § 5.53(d) specifies that this approval requirement does not apply to a change in composition of all, or substantially all, of a bank's assets that the bank undertakes in response to direction from the OCC (e.g., in an enforcement action pursuant to 12 U.S.C. 1818) or pursuant to a statute or regulation that requires OCC review or approval (e.g., a voluntary liquidation pursuant to 12 U.S.C. 181 and 12 CFR 5.48).

We note that the acquisition of deposits by a dormant bank raises the presumption that the bank intends to use the deposits to fund an increase in assets, which would trigger this proposal's application requirement. A dormant bank should not gather deposits to fund its asset acquisition without first seeking the approval of the OCC pursuant to this proposal.

In reviewing applications filed under § 5.53, we will consider the purpose of the transaction, its impact on the safety and soundness of the bank, and any effect on the bank's customers. Relevant to our consideration of an application to dispose of all or substantially all of the bank's assets will be the reasons for the proposed decrease in asset size and future plans for the bank charter (including any plans for liquidation), future asset growth, future plans to market or sell the charter, and future business plans, as applicable. Depending on the circumstances presented in the bank's application, our approval of the bank's disposition of all or substantially all of its assets will address how long the dormant charter may continue, and could include a requirement that the bank submit a plan of liquidation.

In reviewing an application in connection with an increase in the assets of a stripped charter, we will consider the bank's future business plan and whether this plan involves activities that significantly deviate from

<sup>1</sup> The OCC defines a significant deviation from a bank's business plan or operations to include a material deviation or material change in the bank's: (1) Projected growth, such as planning significant growth in a product or service; (2) strategy or philosophy, such as significantly reducing the emphasis of its targeted niche (for example, small business lending) in favor of significant expansion of another area (for example, funding large commercial real estate projects); (3) lines of business, such as initiating a new program for subprime lending; (4) funding sources, such as shifting from core deposits to brokered deposits; (5) scope of activities, such as establishing transactional Internet banking or entering new, untested markets; (6) stock benefit plans for *de novo*

the bank's original business plan or operations prior to its stripped status. We also will consider the applicant's staffing plans, plans for oversight of the activity within the bank, and accountability to the board of directors, along with the applicant's plans to acquire, develop, or modify internal control systems adequate to monitor the new activity.

This proposal also provides that, where a national bank has sold or otherwise disposed of its assets in a transaction requiring approval pursuant to this new § 5.53, our review of any subsequent growth in assets pursuant to this proposal will include, among other things, the factors governing the organization of a *de novo* bank under 12 CFR 5.20. In evaluating an application to establish a *de novo* bank, we consider whether the proposed bank: (1) Has organizers who are familiar with national banking laws and regulations; (2) has competent management, including a board of directors, with ability and experience relevant to the types of services to be provided; (3) Has capital that is sufficient to support the projected volume and type of business; (4) Can reasonably be expected to achieve and maintain profitability; and (5) Will be operated in a safe and sound manner. In addition, § 5.20(f) provides that we also may consider additional factors listed in section 6 of the Federal Deposit Insurance Act, 12 U.S.C. 1816, including the risk to the Federal deposit insurance fund, and whether the proposed bank's corporate powers are consistent with the purposes of the Federal Deposit Insurance Act and the National Bank Act.

*Reference to "business plan."* This proposal makes a conforming change to § 5.20 to provide that any use of the term "operating plan" or "operating plans" will be changed to "business plan or operating plan" or "business plans or operating plans," as appropriate. Currently, § 5.20 only uses the term "operating plan" when referring to the document that describes a national bank's management goals, earnings objectives, and lines of business. However, the banking industry, as well as the OCC and the other Federal financial institution agencies in policy statements, applications, and internal documents, more commonly use the term "business plan." The OCC has made this change to avoid any confusion about whether a substantive difference between the two terms is intended. Thus, the OCC intends that both terms may be used interchangeably.

### III. Comment Solicitation

The OCC requests comment on all aspects of this proposal, including the specific issues that follow.

#### *Community Bank Comment Request*

The OCC seeks comment on the impact of this proposal on community banks. The OCC recognizes that community banks operate with more limited resources than larger institutions and may present a different risk profile. Thus, the OCC specifically requests comment on the impact of the proposal on community banks' current resources and available personnel with the requisite expertise, and whether the goals of the proposal could be achieved, for community banks, through an alternative approach.

#### *Solicitation of Comments on Use of Plain Language*

Section 722 of the Gramm-Leach-Bliley Act, Public Law 106-102, section 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. We invite your comments on how to make this proposal easier to understand. For example:

- Have we organized the material to suit your needs? If not, how could this material be better organized?
- Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?
- Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?
- What else could we do to make the regulation easier to understand?

### IV. Regulatory Analysis

#### *A. Regulatory Flexibility Act*

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Comptroller of the Currency certifies that this proposal will not have a significant economic impact on a substantial number of small entities.

#### *B. Unfunded Mandates Reform Act of 1995*

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before

promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC has determined that this proposal will not result in expenditures by State, local, or tribal governments or by the private sector of \$100 million or more. Accordingly, the OCC has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

#### *C. Executive Order 12866*

The Comptroller of the Currency has determined that this rule does not constitute a "significant regulatory action" for the purposes of Executive Order 12866.

#### *D. Paperwork Reduction Act of 1995*

In accordance with the requirements of the Paperwork Reduction Act of 1995, the OCC may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The information collection requirements contained in this notice of proposed rulemaking have been submitted to OMB for review and approval under OMB Control Number 1557-0014.

This proposal is expected to increase annual paperwork burden for respondents by adding certain application requirements. The information collection requirements are contained in § 5.53. Section 5.53 requires a national bank to submit an application to the OCC before changing the composition of all, or substantially all, of its assets through sales or other dispositions or, having sold or disposed of all or substantially all of its assets, through subsequent purchases or other acquisitions. The time per response to complete an application is estimated to be five hours and the number of respondents is estimated to be five national banks. The likely respondents are national banks.

*Estimated number of respondents:* 5.

*Estimated number of responses:* 5.

*Estimated total burden hours per response:* 5 hours.

*Estimated total annual burden hours:* 25 hours.

The OCC invites comments on: (1) Whether the collection of information contained in the proposed rulemaking is

necessary for the proper performance of the OCC's functions, including whether the information has practical utility;

(2) The accuracy of the OCC's estimate of the burden of the information collection, including the validity of the methodology and assumptions used;

(3) Ways to enhance the quality, utility, and clarity of the information to be collected;

(4) Ways to minimize the burden of the information collection on respondents; including the use of automated collection techniques or other forms of information technology; and

(5) Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

Comments should be sent to: John Ference, Clearance Officer, Office of the Comptroller of the Currency, Legislative and Regulatory Activities Division, Attention: 1557-0194, 250 E Street, SW., Mailstop 8-4, Washington, DC 20219. Due to delays in paper mail in the Washington area, commenters are encouraged to submit their comments by fax to (202) 874-4889 or by e-mail to [camille.dixon@occ.treas.gov](mailto:camille.dixon@occ.treas.gov). Joseph F. Lackey, Jr., Desk Officer, Office of Information and Regulatory Affairs, Attention: 1557-0014, Office of Management and Budget, Room 10235, Washington, DC 20503. Comments may also be sent by e-mail to [jlackeyj@omb.eop.gov](mailto:jlackeyj@omb.eop.gov).

#### List of Subjects in 12 CFR Part 5

Administrative practice and procedure, National banks, Reporting and recordkeeping requirements.

#### Authority and Issuance

For reasons set forth in the preamble, the OCC proposes to amend part 5 of chapter I of title 12 of the Code of Federal Regulations as follows:

#### PART 5—RULES, POLICIES, AND PROCEDURES FOR CORPORATE ACTIVITIES

1. The authority citation for part 5 is revised to read as follows:

**Authority:** 12 U.S.C. 1 *et seq.*, 24a, 24(Seventh), 93a, 1818, and 3101 *et seq.*

2. In § 5.20, revise all references to “operating plan” or “operating plans” to read “business plan or operating plan” or “business plans or operating plans,” as appropriate.

3. In Subpart D—Other Changes in Activities and Operations, a new § 5.53 is added to read as follows:

#### § 5.53 Change in asset composition.

(a) *Authority.* 12 U.S.C. 93a, 1818.

(b) *Scope.* This section requires a national bank to obtain the approval of the OCC before changing the composition of all, or substantially all, of its assets through sales or other dispositions or, having sold or disposed of all or substantially all of its assets, through subsequent purchases or other acquisitions.

(c) *Approval requirement.* (1) A national bank must file an application and obtain the prior written approval of the OCC before changing the composition of all, or substantially all, of its assets (i) through sales or other dispositions or, (ii) having sold or disposed of all or substantially all of its assets, through subsequent purchases or other acquisitions.

(2) In determining whether to approve an application under paragraph (c)(1) of this section, the OCC will consider the purpose of the transaction, its impact on the safety and soundness of the bank, and any effect on the bank's customers, and may deny the application if the transaction would have a negative effect in any such respect. Where a national bank has sold or otherwise disposed of all or substantially all of its assets in a transaction requiring approval under paragraph (c)(1)(i) of this section, the OCC's review of any subsequent change in asset composition through purchase or other acquisition will include, in addition to the foregoing factors, the factors governing the organization of a bank under § 5.20.

(d) *Exception.* This section does not apply to a change in composition of all, or substantially all, of a bank's assets that the bank undertakes in response to direction from the OCC (e.g., in an enforcement action pursuant to 12 U.S.C. 1818) or pursuant to a statute or regulation that requires OCC review or approval (e.g., a voluntary liquidation pursuant to 12 U.S.C. 181 and 12 CFR 5.48).

Dated: December 30, 2003.

John D. Hawke, Jr.,

Comptroller of the Currency.

[FR Doc. 04-247 Filed 1-6-04; 8:45 am]

BILLING CODE 4810-33-P

**UNIVERSITY OF KENTUCKY  
24<sup>th</sup> ANNUAL CONFERENCE ON  
LEGAL ISSUES FOR FINANCIAL INSTITUTIONS**

**April 16, 2004**

**Tax Planning for Financial Institutions and Their Holding Companies in Light of the  
Illinois Tool Company Decision and Proposed Legislation**

**By**

**Thomas J. Luber  
Wyatt, Tarrant & Combs, LLP  
2800 PNC Plaza  
Louisville, KY 40202  
(502) 562-7214  
*tluber@wyattfirm.com***



# TAX PLANNING FOR FINANCIAL INSTITUTIONS AND THEIR HOLDING COMPANIES IN LIGHT OF THE ILLINOIS TOOL COMPANY DECISION AND PROPOSED LEGISLATION

<b>I.</b>	<b>ILLINOIS TOOL WORKS, ET AL. V. REVENUE CABINET .....</b>	<b>K(b)-3</b>
A.	The Case .....	K(b)-3
B.	Timing of the Opinion .....	K(b)-3
<b>II.</b>	<b>THE IMPACT OF THE CORPORATE LICENSE TAX ON CORPORATE GROUPS WITHOUT KRS 136.071 .....</b>	<b>K(b)-3</b>
A.	Overview .....	K(b)-3
B.	Examples .....	K(b)-4
	Example #1 .....	K(b)-5
	Example #2 .....	K(b)-6
	Example #3 .....	K(b)-7
	Example #4 .....	K(b)-8
	Example #5 .....	K(b)-9
	Example #6 .....	K(b)-10
	Example #7 .....	K(b)-11
	Example #8 .....	K(b)-12
	Example #9 .....	K(b)-13
	Exhibit A .....	K(b)-14
<b>III.</b>	<b>PLANNING TO AVOID THE KENTUCKY LICENSE TAX ON BANK HOLDING COMPANIES .....</b>	<b>K(b)-15</b>
A.	Eliminate the Bank Holding Company .....	K(b)-15
B.	Convert the Bank Holding Company to a Limited Liability Company, Taxed as a Corporation for Federal Tax Purposes .....	K(b)-15
C.	Move the Bank Holding Company to a Tax Friendly State .....	K(b)-15
D.	Wait for a Legislative Fix .....	K(b)-17
<b>IV.</b>	<b>TAX MODERNIZATION .....</b>	<b>K(b)-17</b>
A.	The ITW Provisions .....	K(b)-17
B.	House Bill 352 .....	K(b)-17

<b>V.</b>	<b>OTHER ISSUES ARISING FROM THE TAX MODERNIZATION PROPOSAL THAT IMPACT FINANCIAL INSTITUTIONS .....</b>	<b>K(b)-17</b>
A.	Taxation of LLC's and Other Entities .....	K(b)-17
B.	Nexus .....	K(b)-18
C.	Mandatory Consolidation of Entities Within The Corporate Group .....	K(b)-18
D.	Reduction of the Corporate Tax Rate .....	K(b)-20
E.	Application of a Minimum Tax Computation .....	K(b)-20
F.	Application of the Entity Tax Credit .....	K(b)-20
G.	Taxation of LLC Distributions .....	K(b)-21
<b>VI.</b>	<b>MAKING THE S ELECTION AT THE HOLDING COMPANY LEVEL .....</b>	<b>K(b)-22</b>
A.	Who Can Qualify .....	K(b)-22
B.	Electing for an LLC .....	K(b)-22
C.	Section 1374 Issues .....	K(b)-22
D.	The Advantages Under Federal Law .....	K(b)-23
E.	The Advantage Under Kentucky Law .....	K(b)-23

## **I. ILLINOIS TOOL WORKS, ET AL. V. REVENUE CABINET.**

**A. The Case.** The Illinois Tool Works (“ITW”) decision was handed down by Franklin Circuit Court on December 5, 2002. KRS 136.071 allowed for reductions to the capital employed in Kentucky of certain Kentucky commercially domiciled corporations for purposes of computing the corporate license tax under KRS 136.070. Non-domiciled companies were not afforded the same benefit. A group of non-Kentucky domiciled companies brought the case challenging the constitutionality of the statute under the equal protection and commerce clauses of the United States Constitution. The Court held that KRS 136.071 was unconstitutional in its entirety as discriminatory against interstate commerce in violation of the Commerce Clause of the United States Constitution. The arguments requesting that the seven words involving “domiciled” be struck from the statute were rejected. Arguments that both KRS 136.070 and 136.071 should be struck were also rejected.

**B. Timing of the Opinion.** The impact of the opinion was originally set to apply to “any and all years ending after the date of the opinion and order” (December 5, 2002). On motion for reconsideration, the court subsequently amended its order to “any and all tax years for which a corporation license tax return is due (before extension) on or after April 15, 2004. These returns would cover the corporate operations for calendar/fiscal years beginning on or after January 1, 2003.” The impact of the change was to generally postpone the effect of the original order from December 31, 2002 to December 31, 2003 to give the Kentucky Legislature the opportunity to address the issue during its regular legislative session in calendar year 2003.

## **II. THE IMPACT OF THE CORPORATE LICENSE TAX ON CORPORATE GROUPS WITHOUT KRS 136.071**

**A. Overview.** The reason that KRS 136.071 was in the Kentucky law was to eliminate the application of the Kentucky license tax at each level of a multi-level corporate structure.

KRS 136.071 States:

- (1) Notwithstanding any other provisions of this chapter, a corporation whose commercial domicile is in this state and holds directly or indirectly stock or securities in other corporations equal to or greater than fifty percent (50%) of its total assets may, at the option of the taxpayer, be considered as one (1) corporation for purposes of determining and apportioning total “capital,” or compute its “capital” under KRS 136.070(2) as follows:
  - (a) Determine the corporation’s total capital as provided in KRS 136.070(2).
  - (b) Deduct from the amount determined in subsection (a) of this section, the book value of its investment



in the stock and securities of any corporation in which it owns more than fifty percent (50%) of the outstanding stock of such corporation.

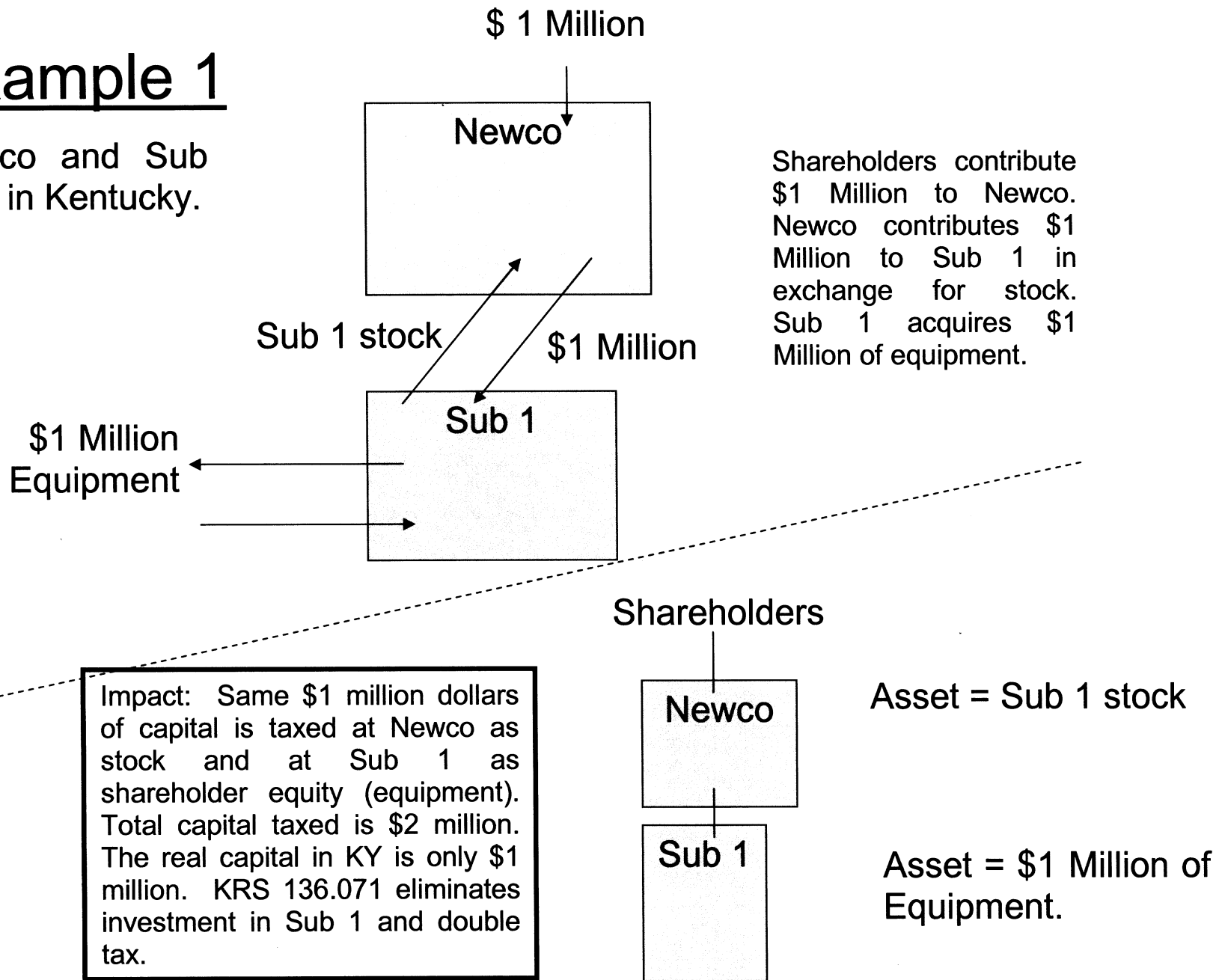
- (2) For purposes of determining the ratio of stock and securities to total assets, the value shall be the value of the accounts as reflected on financial statements prepared for book purposes as of the last day of the calendar or fiscal year. The term "stock and securities" as used in this section means shares of stock in any corporation, certificates of stock or interest in any corporation, notes, bonds, debentures, and evidences of indebtedness. The term "book value" means the value as shown on financial statements prepared for book purposes as of the last day of the calendar or fiscal year.

The denial of the right to file a consolidated return or to eliminate investments in subsidiary stock causes the corporate group to pay tax on capital that does not exist.

**B. The Following Examples Illustrate the Workings of KRS 136.070 Without KRS 136.071.** These examples were used to explain the need for a legislative solution to both the Kentucky Revenue Cabinet and the Kentucky Legislature.

# Example 1

Newco and Sub both in Kentucky.



## Example 2

Shareholders

Newco and all  
Subs in KY

Tax on \$1 Million of  
capital in the form  
of Stock

Newco

\$1 Million

Tax on \$1 million of capital (in the form of  
shareholder equity)  
(\$250,000 equipment + \$750,000 stock)

Sub  
1

\$1 Million

Tax on \$750,000 of capital (in the form of  
shareholder equity)  
(\$250,000 equipment + \$500,000 stock)

Sub  
2

\$750,000

Tax on \$500,000 of capital (in the form of  
shareholder equity)  
(\$250,000 equipment + \$250,000 stock)

Sub  
3

\$500,000

Tax on \$250,000 of capital (in the form of  
shareholder equity)  
(\$250,000 equipment)

Sub  
4

\$250,000

\$1 Million transferred  
from Newco to Sub 1  
down to Sub 4; each  
Sub retains \$250,000  
as capital and  
contributes the  
remainder to lower  
Sub in exchange for  
stock of Sub.

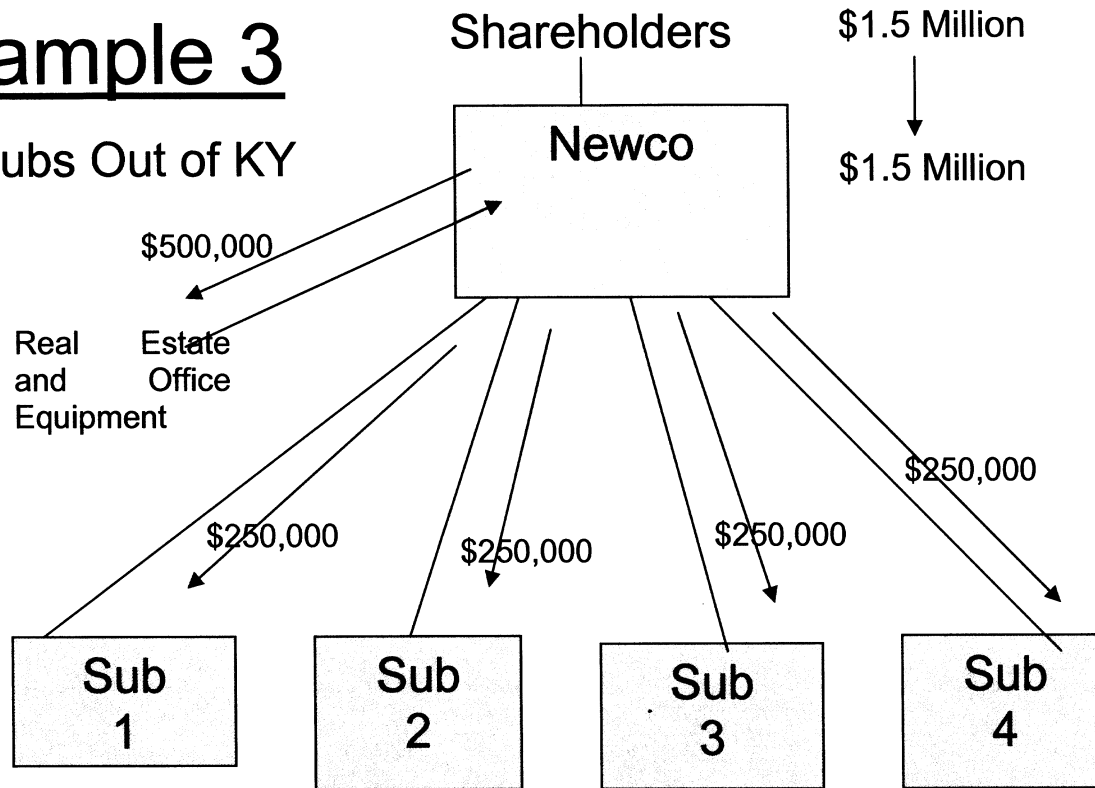
Impact: Same \$1 Million  
creates \$3.5 Million of  
total taxable capital.

With KRS 136.071,  
taxable capital is \$1  
Million.

Result: Total tax on \$3.5 Million of capital.

# Example 3

All Subs Out of KY

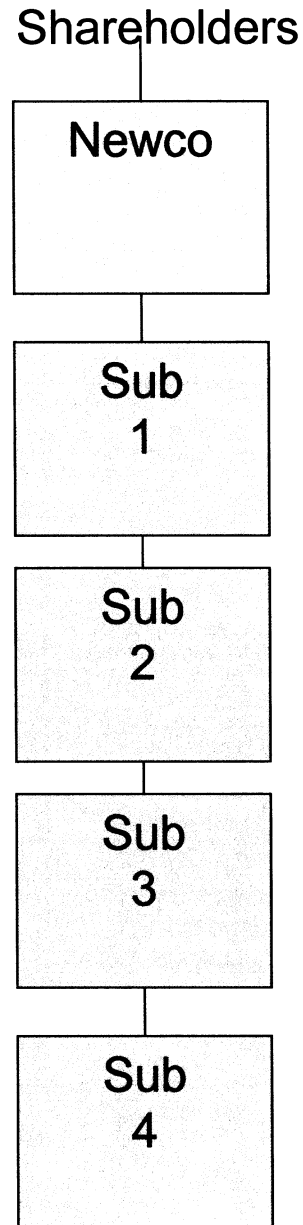


Same as Example 2, except Subs 1, 2, 3, and 4 are brother-sister subsidiaries, and rather than \$1 Million, shareholders of Newco contribute \$1.5 Million and Newco acquires \$500,000 of office real estate and office equipment. Newco transfers \$250,000 to each Sub in exchange for stock.

Impact: With KRS 136.071, taxable capital of \$500,000. Without KRS 136.071, taxable capital of \$1.5 Million. Discourages companies from locating their headquarters in Kentucky because stock of out of state subsidiaries are included in taxable capital.

## Example 4

Only Sub 4 Does  
Business in KY



\$1 Million

\$1 Million

\$1 Million

\$750,000

\$500,000

\$250,000

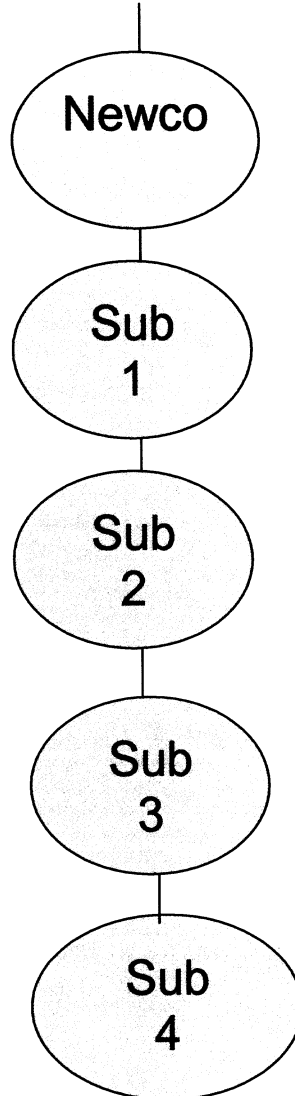
Same as Example 2,  
except only lowest tier  
subsidiary does business  
in Kentucky. Newco and  
Subs 1, 2, and 3 are out  
of state.

Impact: Sub 4 pays  
tax on \$250,000 of  
taxable capital.  
Companies are  
discouraged to locate  
headquarters and  
subsidiaries in  
Kentucky. Advantage  
to do business in  
Kentucky only in the  
lowest tier subsidiary.

## Example 5

Newco and all subsidiaries are “Check the Box” LLC’s (taxed as corporations).

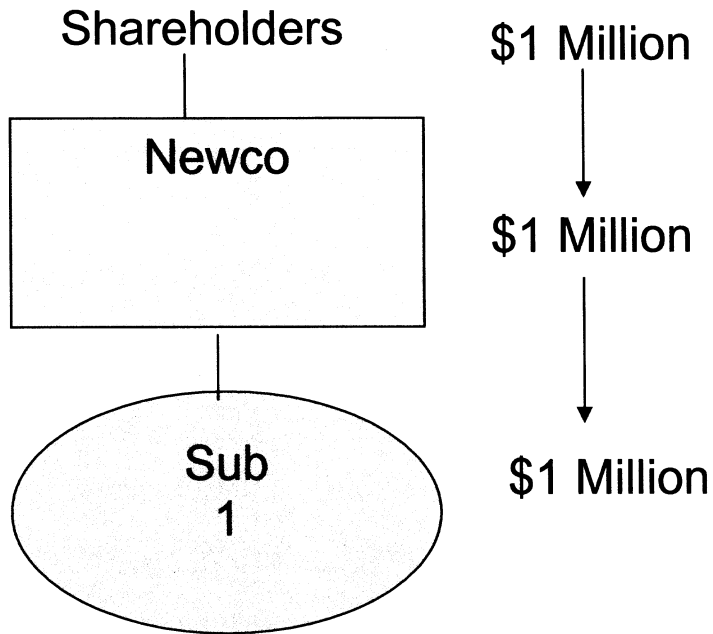
Shareholders



Impact: No license tax.  
Creates planning opportunity for companies to do business in Kentucky as “Check the Box” LLC’s which are exempt from the Kentucky license tax.

## Example 6

Same as Example 1, except Newco is a corporation and Sub 1 is a “Check the Box” LLC. Shareholders contribute \$1 Million to Newco in exchange for stock. Newco contributes \$1 Million to Sub 1 in exchange for LLC interest.



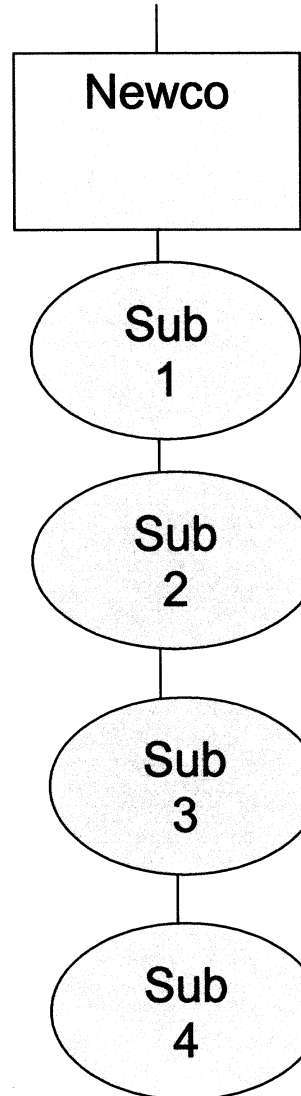
Impact: Newco is taxed on \$1 Million interest in Sub 1. Sub 1 is exempt from license tax as an LLC. No double tax – same result as with KRS 136.071. Creates planning opportunity for companies to organize as “Check the Box” LLC’s in Kentucky.

## Example 7

Subs are “Check the Box” LLC’s.

Same as Example 2, except Subs are LLC’s rather than corporations. Shareholders contribute \$1 Million to Newco. Newco contributes \$1 Million to Sub 1 down to Sub 4; each Sub retains \$250,000 as capital and contributes remainder to lower Sub in exchange for stock of Sub.

Shareholders

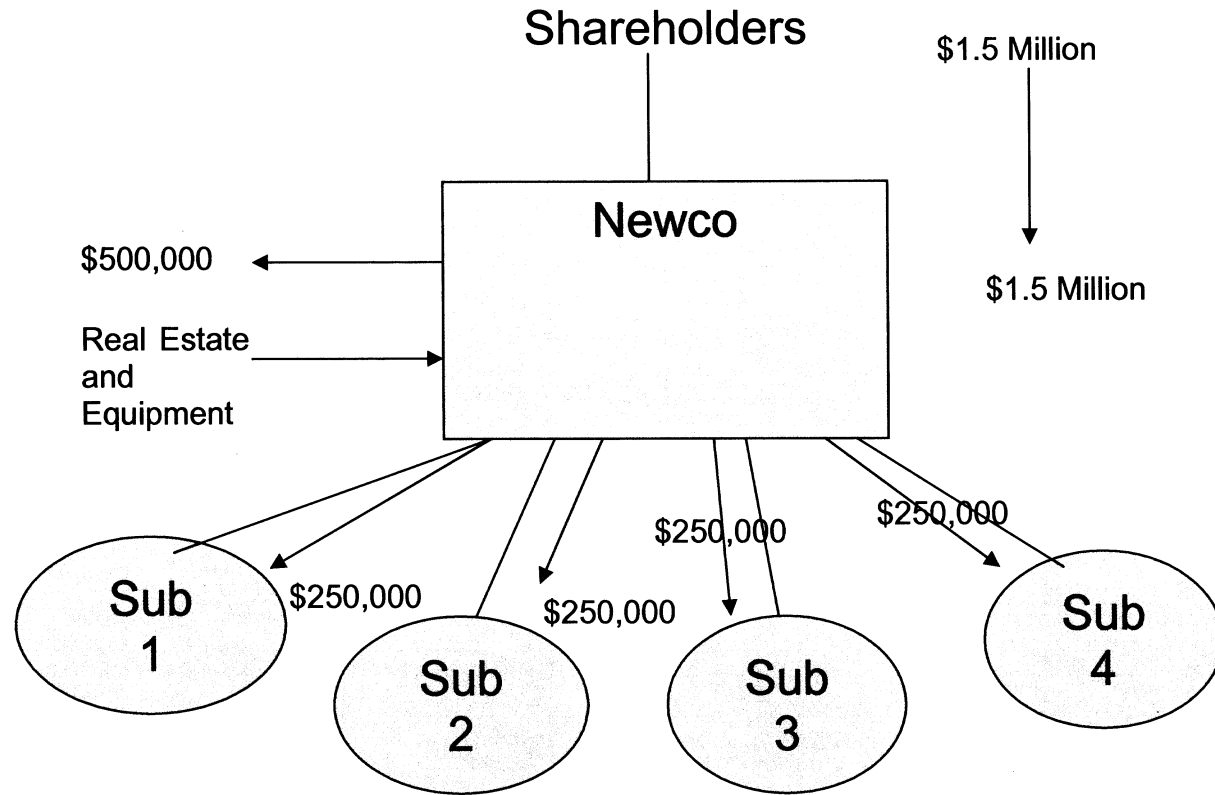


Impact: Newco pays license tax on \$1 Million investment in Sub 1. No double taxation.



## Example 8

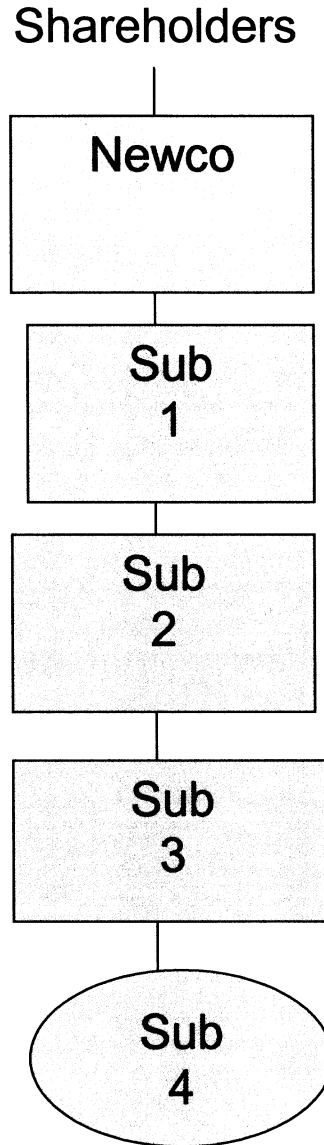
Same as Example 3, except Subs are out of state "Check the Box" LLC's.



Impact: Newco's taxable capital is the same as it would be without KRS 136.071 (\$1.5 Million -- \$500,000 + \$1 Million investment in the LLC's. Owning out of state LLC interests does not held a company headquartered in Kentucky plan around the loss of KRS 136.071.

## Example 9

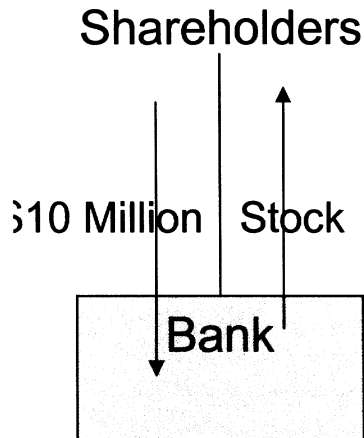
Same as Example 4, Newco and Subs 1, 2, and 3 are out of state, except Sub 4 is doing business in Kentucky as a “Check the Box” LLC.



Impact: No license tax. To the extent that a company can do business in Kentucky as a “Check the Box” LLC, there is no difference with or without KRS 136.071. Creates incentive to organize and operate in Kentucky as a “Check the Box” LLC.

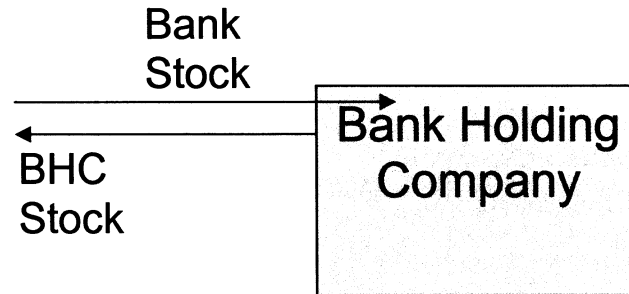
# BANK HOLDING COMPANY

## KY License Tax Example

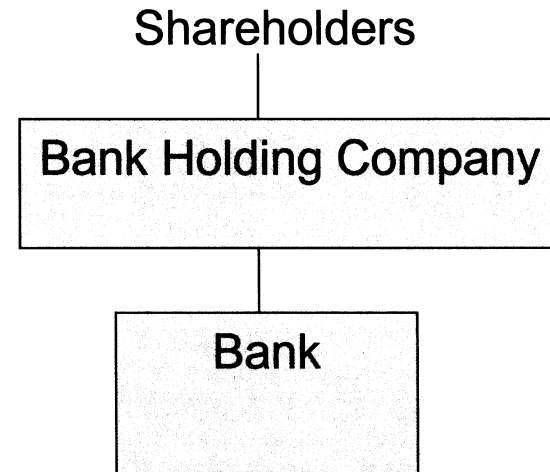


K(b) - 14

Shareholders contribute \$10 Million to Bank in exchange for stock. Taxable capital for KY license tax is **\$0** because financial institutions are exempt from license tax.



Shareholders contribute Bank stock, worth \$10 Million, to Bank Holding Company in exchange for BHC stock worth \$10 Million.



Taxable capital for KY license tax is **\$10 Million** without KRS 136.071 exclusion for investment in subsidiaries.

### **III. PLANNING TO AVOID THE KENTUCKY LICENSE TAX ON BANK HOLDING COMPANIES**

#### **A. Eliminate the Bank Holding Company.**

1) In certain instances it may make sense to eliminate the bank holding company structure. By doing so, the bank becomes the top tier entity whose shares are held by the ultimate shareholders. Since banks are not subject to the corporate license tax by statute, eliminating the bank holding company would avoid the adverse impact of the *Illinois Tool Works* case.

2) A variation on this theme would be to separate the bank from the holding company and leave the holding company and any non-banking operations held by the holding company as a separate entity subject to the corporate license tax. The shareholders would then own shares in two organizations -- the bank and the non-bank holding company. This structure eliminates the double tax impact caused by owning a bank and places the holding company in the same position as other non-banking entities waiting for a legislative fix by reenacting KRS 136.071 or repealing KRS 136.070.

**B. Convert the Bank Holding Company to a Limited Liability Company, Taxed as a Corporation for Federal Tax Purposes.** Currently under Kentucky law, limited liability companies are not subject to the corporate license tax. If the bank holding company was to convert from a Kentucky corporation to a Kentucky limited liability company which is taxed as a corporation for Federal tax purposes, by merging into the limited liability company, the merger transaction would be exempt for Federal income tax purposes and under current Kentucky law, the limited liability company would not be subject to Kentucky's corporate license tax. This option may be a good one for a bank whose bank holding company has a small number of shareholders, wants to keep a holding company structure and wants to have more certainty that it will not incur the corporate license tax in 2004 than is provided in the option of relying solely on the ability and willingness of the Kentucky legislature to enact corrective legislation in 2004, 2005 or 2006.

#### **C. Move the Bank Holding Company to a Tax Friendly State.**

1) Overview. A new bank holding company could incorporate in another "tax-friendly" state in order to avoid Kentucky state taxation entirely at the holding company level. Two contiguous jurisdictions that we have identified as

having favorable state taxing structures<sup>1</sup> are Indiana and Virginia.<sup>2</sup> States to also consider are Delaware, Florida and Nevada.

2) Indiana. Indiana imposes a financial institutions franchise tax for the privilege of exercising the franchise or the corporate privilege of transacting business of a financial institution in Indiana. The franchise tax rate is eight and one half percent (8.5%) of the financial institution's adjusted gross income.<sup>3</sup> A holding company carrying on the business of a financial institution is exempt from Indiana's corporation adjusted gross income tax. Additionally, the Indiana intangible property tax has been repealed. Indiana does not have a corporate license tax like Kentucky.

3) Virginia. Virginia imposes a corporation income tax at a rate of six percent (6%) of Virginia taxable income. It does not have a state corporation license tax. There is a state and local bank franchise tax on net capital, but a bank holding company is not subject to this tax. Virginia does not tax intangible personal property.

4) Establishing Sufficient Nexus. If the bank holding company chooses to reincorporate in another jurisdiction, the bank holding company must establish sufficient activity in that jurisdiction to establish legal nexus. This is important to ensure that the activities of the bank holding company will not be taxed in Kentucky. Kentucky could assert that the bank holding company is just a sham corporation organized to avoid Kentucky taxes and as such that its income and capital should be taxed in Kentucky. Additionally, if the bank holding company does not relinquish all of its presence and activities in Kentucky, Kentucky could assert that the bank holding company has retained a physical and/or economic presence in the state which provides sufficient nexus with Kentucky to tax the bank holding company. To establish sufficient nexus activity in another jurisdiction a bank holding company should lease office space, maintain a bank account and incur operating expenses in the jurisdiction. The bank holding company should have employees in the jurisdiction. This can be accomplished by hiring at least one employee there, to the extent existing officers and employees in the banking group do not want to "relocate" there. The bank holding company should respect normal corporate formalities such as holding meetings of the board of directors within the jurisdiction. It is important that the bank holding company

---

<sup>1</sup> Our analysis of the states' taxing structures focused primarily on (1) corporate income taxes; (2) corporate franchise/license taxes; and (3) intangible property taxes, as being the most relevant for a bank holding company.

<sup>2</sup> We analyzed the tax structure of all of the states that are contiguous to Kentucky and determined that Indiana and Virginia were the most "tax friendly".

<sup>3</sup> Indiana adjusted gross income is defined as federal taxable income under §63 under the IRC.

has economic substance and therefore as many of the above activities as practical should take place within the new jurisdiction. If the bank holding company is considered a sham corporation, lacking economic substance, its income and capital are likely taxable in Kentucky.

**D. Waiting for a Legislative Fix.**

- 1) Tax Modernization contains a fix for the ITW decision.
- 2) The 2003 (90/10) legislative fix vetoed by Governor Patton is still being reviewed by the courts. It is possible that the Governor's veto may be overturned.

**IV. TAX MODERNIZATION**

**A. The ITW Provisions.**

- 1) The 2003 tax year. The budget bill contains provisions that make KRS 136.071 apply to tax year 2003.
- 2) The Future Years. The budget bill provides that the corporate license tax is repealed effective December 31, 2004.

**B. House Bill 352.** The KBA had legislation introduced that would have removed from the computation of capital the holding company's interests in financial institution stock.

**V. OTHER ISSUES ARISING FROM THE TAX MODERNIZATION PROPOSAL THAT IMPACT FINANCIAL INSTITUTIONS.**

**A. Taxation of LLC's and Other Entities.** The proposal contains a new definition of corporations subject to Kentucky corporate tax. The following entities are now defined as "corporations" in Kentucky:

- 1) "Corporations" as defined in Section 7701(a)(3) of the Internal Revenue Code;
- 2) S corporations as defined in Section 1361(a) of the Internal Revenue Code;
- 3) A foreign limited liability company as defined in KRS 275.015(6);
- 4) A limited liability company as defined in KRS 275.015(8);
- 5) A professional limited liability company as defined in KRS 275.015(19);
- 6) A foreign limited partnership as defined in KRS 362.401(4);
- 7) A limited partnership as defined in KRS 362.401(7);

- 8) A registered limited liability partnership as defined in KRS 362.155(7);
- 9) A real estate investment trust as defined in Section 856 of the Internal Revenue Code;
- 10) A regulated investment company as defined in Section 851 of the Internal Revenue Code;
- 11) A real estate mortgage investment conduit as defined in Section 860D of the Internal Revenue Code; and
- 12) A financial asset securitization investment trust as defined in Section 860L of the Internal Revenue Code.

**B. Nexus.** The proposal contains the following definition of “Doing Business” in Kentucky:

- 1) “Doing business in this state” includes, but is not limited to:
  - a. Being organized under the laws of this state;
  - b. Having a commercial domicile in this state;
  - c. Owning or leasing property in this state;
  - d. Having one (1) or more individuals performing services in this state;
  - e. Maintaining an interest in a general partnership doing business in this state;
  - f. Deriving income from or attributable to sources within this state, including deriving income directly or indirectly from a trust doing business in this state; or
  - g. Directing activities at Kentucky customers for the purpose of selling them goods or services that are not otherwise protected by Pub. L. No. 86-272.

**C. Mandatory Consolidation of Entities Within the Corporate Group.** The proposal contains the following provisions relating to consolidations:

- 1) Affiliated Group. One (1) or more chains of includible corporations connected through stock ownership, membership interest, or partnership interest with a common parent corporation if:
  - a. The common parent owns directly an ownership interest meeting the requirements of subparagraph (c) below in at least one (1) other includible corporation; and

- b. An ownership interest meeting the requirements of subparagraph (c) below in each of the includible corporations, excluding the common parent, is owned directly by one (1) or more of the other corporations.
- c. The ownership interest of any corporation meets the requirements of this paragraph if the ownership interest encompasses at least eighty percent (80%) of the voting power of all classes of ownership interests and has a value equal to at least eighty percent (80%) of the total value of all ownership interests.

2) Common Parent Corporation. The member of an affiliated group that meets the ownership requirement of subparagraphs (a) and (b) above.

3) Includible Corporation. Any corporation that is doing business in this state except:

- a. Corporations exempt from corporation income tax under paragraphs (a) to (h) of subsection (1) of Section 6 of the Act;
- b. Foreign corporations;
- c. Corporations with respect to which an election under Section 936 of the Internal Revenue Code is in effect for the taxable year;
- d. Real estate investment trusts as defined in Section 856 of the Internal Revenue Code;
- e. Regulated investment companies as defined in Section 851 of the Internal Revenue Code;
- f. A domestic international sales company as defined in Section 992(a)(1) of the Internal Revenue Code;
- g. An S corporation as defined in Section 1361(a) of the Internal Revenue Code;
- h. Any corporation that realizes a net operating loss whose Kentucky property, payroll, and sales factors pursuant to subsection (8) of Section 10 of the Act are de minimis; and
- i. Any corporation for which the sum of the property, payroll and sales factors described in subsection (8) of Section 9 of the Act is zero.

4) Ownership Interest. Means stock, a membership interest in a limited liability company, or a partnership interest in a limited partnership or limited liability partnership;



5) **Consolidated Return Filing.** The proposal contains the following language:

- a. An affiliated group, whether or not filing a federal consolidated return, shall file a consolidated return which includes all includible corporations.
- b. An affiliated group required to file a consolidated return under this subsection shall be treated for all purposes as a single corporation under the provisions of this chapter. All transactions between corporations included in the consolidated return shall be eliminated in computing net income in accordance with subsection (13) of Section 2 of the Act, and in determining the property, payroll, and sales factors in accordance with Section 9 of the Act.

**D. Reduction of the Corporate Tax Rate.** The Tax Modernization proposal includes a reduction in the corporate tax rate from 8.25% to 6% for tax years beginning on or after January 1, 2005.

**E. Application of a Minimum Tax Computation.** The proposal contains the following language imposing an alternative gross receipts computation.

- 1) An alternative minimum calculation of nine and one-half cents (\$0.095) per one hundred dollars (\$100) of the corporation's gross receipts. For purposes of this paragraph, gross receipts means the numerator of the sales factor under the provisions of paragraph (c) of subsection (8) of Section 9 of the Act.
- 2) A minimum of two hundred fifty dollars (\$250) shall be due for the taxable year from each corporation subject to the tax imposed by this section, regardless of the application of any tax credits provided under this chapter or any other provision of the Kentucky Revised Statutes for which the business entity may qualify.
- 3) **Sales under Paragraph (c) of Subsection (8) of Section 9 of the Act.**
  - a. Sales of tangible personal property...
  - b. Sales, other than sales of tangible personal property, are in this state if the income-producing activity is performed in this state; or the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

**F. Application of the Entity Tax Credit.** The proposal contains the following language allowing a credit for the new entity level tax:

1) Resident and nonresident individuals who are partners in a partnership, members in a limited liability company electing partnership tax treatment for federal income tax purposes, shareholders in an S corporation, or owners of a single member limited liability company shall be entitled to a nonrefundable credit against the tax imposed under Section 4 of the Act for their proportionate share of income tax due as determined under Section 6 of the Act before the application of any credits identified in subsection (4) of Section 5 of the Act and reduced by the required minimum imposed by subsection (6) of Section 6 of the Act. The credit determined under this subsection shall not operate to reduce the tax due to an amount that is less than what would have been payable were the income attributable to doing business in this state by the partnership, limited liability company, or S corporation ignored.

**G. Taxation of LLC Distributions.** The proposal contains the following language concerning the taxation of distributions:

1) For partnerships, limited liability companies electing partnership tax treatment for federal income tax purposes, single member limited liability companies whose member is an individual, and S corporation subject to tax under the provisions of Section 6 of the Act, the individual partner, member, or shareholder's distributive share shall be computed as nearly as practicable in a manner identical to that required for federal income tax purposes except to the extent required by differences between this chapter and the federal income tax law and regulations.

2) Resident individuals who are partners in a partnership, members in a limited liability company electing partnership tax treatment for federal income tax purposes, owners of a single member limited liability company, or shareholders in an S corporation subject to the tax imposed by Section 6 of the Act must report and pay tax on the distributive share of net income, gain, loss, deduction, or credit, as determined in paragraph (a) above.

3) A limited liability company shall file a Kentucky corporate income tax return and determine its Kentucky income tax liability as provided in Section 6 of the Act regardless of the tax treatment elected for federal income tax purposes. All other income tax issues not expressly addressed by the provisions of this chapter shall be treated in the same manner as the issues are treated for federal income tax purposes.

Since the entities are defined for Kentucky law as corporations, it is less than clear that the distribution from LLCs taxed as partnerships are not dividends for Kentucky law purposes. This issue should be clarified by the Department of Revenue.

## **VI. MAKING THE S ELECTION AT THE HOLDING COMPANY LEVEL.**

**A. Who can qualify** As is true for any other business considering an S election, a closely held bank or bank holding company must satisfy certain eligibility requirements to be able to take advantage of the opportunity to be treated as a flow-through entity for federal income tax purposes. Meeting these eligibility requirements may require restructuring in certain cases. Any taxpayer making an S election must satisfy the various eligibility requirements for each day of every tax year for which the election is in effect. The eligibility requirements for banks and bank holding companies are as follows:

- 1) The bank or holding company may not use the reserve method of accounting for bad debts.
- 2) The bank or holding company must be a domestic corporation that is not an insurance company subject to tax under Subchapter L, a DISC or former DISC, or a corporation to which §936 applies.
- 3) The bank or holding company must have 75 or fewer shareholders.
- 4) All the bank's or holding company's shareholders must be individuals, estates, or certain kinds of trusts (for tax years beginning after 1997, ESOPs, pension plans, and certain charities will be eligible shareholders).
- 5) The bank or holding company must not have any nonresident aliens as shareholders (i.e., its individual shareholders must be U.S. citizens or residents).
- 6) The bank or holding company can only have one class of stock.
- 7) The bank or holding company must have a permitted tax year.
- 8) An election must be properly filed with the IRS no later than 2 ½ months after the first day of the first tax year for which the election is made.

**B. Electing for an LLC** In order for an LLC to be treated as an S corporation, the LLC needs to make an election to be classified as an association by filing Form 8832, Entity Classification Election, and an election to be an S corporation by filing Form 2553, Election by a Small Business Corporation. Under Treas. Reg. 301.7701-3, generally a domestic eligible entity with two or more members is classified as a partnership unless the entity elects otherwise. The ability of an LLC to make an S election was recognized in PLR 9853045.

**C. § 1374 Issues** Although S corporations are pass-through entities and as such are not subject to tax at the corporate level, a corporation that converts from a C corporation to an S corporation is subject to a corporate level tax on the disposition of any assets held on the date of conversion to the extent that there were "built-in gains" on the conversion date. That is to the extent that any assets with built-in gains on the date of conversion are

disposed of by the S corporation within 10 years following the date of conversion, the S corporation is subject to capital gains tax at the highest corporate rate on the built-in gain. The shareholders of the S corporation also must include the gain on their individual returns, although a credit is provided for taxes paid at the corporate level. The built-in gain for a year can be offset by both built-in losses and C corporation net operating loss carryovers. In addition, the amount of taxable built-in gain for the year is limited to the lesser of; (1) an amount determined by taking into account only recognized built-in gains and losses; (2) the corporation's taxable income for the year; and (3) the amount by which net unrealized gains on the date of conversion exceeds all previously recognized built-in gains.

A bank that makes an S election and changes from the reserve method to the specific charge-off method of accounting for bad debts may be subject to the built-in gain tax on the §481(a) adjustment resulting from the change.

If an LLC elects to be taxed as a C corporation and immediately elects S corporation status, there should be no built-in gains which would be subject to §1374. But if an LLC is taxed as a C corporation, operated in this capacity for a period of time and then elects S corporation status, there may be built-in gain and §1374 would apply upon the conversion.

**D. The Advantages Under Federal Law**

- 1) One level of tax on earnings with an increase in shareholder basis for undistributed earnings.
- 2) Avoidance of double tax upon sale or liquidation of business (except §1374 issues discussed above).
- 3) Alternative Minimum Tax not applicable to S Corporations.
- 4) Pass-Through of Losses.
- 5) Social Security tax considerations.
- 6) Avoidance of Accumulated Earnings Tax.
- 7) Avoidance of personal holding tax.
- 8) Deductibility of interest on debt incurred to purchase S Corporation stock.

**E. The Advantage Under Kentucky Law** Under current Kentucky law, S corporations are subject to the Kentucky corporation income tax only when capital gains are in excess of \$25,000 and comprise more than 50% of their taxable income for the year (which must exceed \$25,000). S corporations subject to the Kentucky corporation income tax are not taxed to the extent that their capital gains would be exempt from federal income tax on built-in gains imposed under IRC §1374. (KRS 141.040(5)).

The taxable income of an S corporation is determined in the same manner as for individual taxpayers, subject to the adjustment required under IRC §1363(b), however, individuals or corporations carrying on a business as an S corporation are liable only in their individual or corporate capacities, and no income tax is assessed upon the income of any S corporation (KRS §141.206(2) & (3)). The taxable income of S corporations must be computed, as nearly as practicable, in the same manner as for federal income tax purposes, except to the extent that a different treatment is required due to differences in the federal and state income tax laws. (KRS 141.206(3)(a).).

Resident individuals who are S corporation shareholders are taxed on their distributive share of the net income, gain, loss, deduction or credit of the S corporation. The Kentucky Revenue Cabinet may, by regulation, require the S corporation to withhold Kentucky income tax on the distributive shares of the entity's shareholders. The distributive share of the S corporation's shareholders is to be computed, as nearly as practicable, in the same manner as for federal income tax purposes, except to the extent that a different treatment is required due to differences in the federal and state income tax laws.

The distributive share of a resident S corporation shareholder's net income from an S corporation subject to the Kentucky bank franchise or savings and loan institution capital stock tax, as well as the portion of the distributive share of a resident S corporation shareholder's net income from an S corporation related to a qualified subchapter S subsidiary subject to the state's bank franchise or savings and loan institution capital stock tax, may be excluded when calculating the resident shareholder's adjusted gross income. (KRS §141.010(10)(j)(1)(a) ; KRS §141.010(10)(j)(1)(b) ).

Under tax modernization, the use of an S Corporation will eliminate any issues regarding the character of distributions.